SEMI-ANNUAL ASESSMENT OF THE WORK PLAN UNDER THE PASA BETWEEN USAID/INDIA AND SEC (JULY 1, 2001-JUNE 30, 2002)

Prepared by

SEC's Office of International Affairs

Submitted to

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General Information

This is the semi-annual assessment of the Work Plan based on the PASA between the USAID and the SEC. The Work Plan is for 12 months (July 1, 2001-June 30, 2002). The semi-annual assessment is for July 1-December, 31, 2001 period. As part of the assessment, the SEC has updated each of the technical assistance and training projects listed in the Work Plan.

Objective

The objective of the Work Plan is for the SEC to assist the SEBI in the following areas:

I. Legal and Regulatory Framework for Investor Protection and Investor Education;
II. Capacity for Regulatory Oversight and Inspection of self-regulatory organizations (SROs) (which include stock exchanges, clearing agencies and depositories) and market participants (which include broker-dealers, registrars and transfer agents, and securities information processors);
III. Capacity for Investigation and Enforcement of securities law violations; and
IV. Disclosure and Reporting Standards, which include accounting and auditing standards.

Tasks

The Work Plan was based on the SEC performing technical assistance and training in four task areas.

Task 1: Strengthening the legal and institutional framework for investor protection.

Task 2: Assisting the SEBI to improve its capacity for regulatory oversight and inspections.

Task 3: Strengthening SEBI's capacity for investigations and enforcement actions for violations of the securities laws.

Task 4: Improvement in disclosure and reporting standards.

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Update of Training and Technical Assistance Projects

- **Review of Issuer Disclosure Documents**

  Task: This training program covered disclosure and financial reporting standards in Task 4.

  Deliverable: A one-week training program on review of issuer disclosure documents. This program is primarily for Newly Independent States of the former Soviet Union and Central and Eastern European countries. This program was held in Budapest, Hungary the week of October 8, 2001. The SEC invited 4 regulators from the SEBI and the exchanges to the training program.

  Counterpart: SEBI and the exchanges

  Target Date: The week of October 8, 2001.

  Status/Comments: The SEC invited 4 regulators from the SEBI and the two major exchanges, the Bombay Stock Exchange ("BSE") and the National Stock Exchange of India ("NSE"). Two persons, one person from the SEBI and one person from the NSE, attended the Disclosure training program in Budapest.

- **International Institute for Securities Enforcement and Market Oversight**

  Task: This institute focused on practical techniques for conducting investigations, market surveillance and inspections of broker-dealers, mutual funds and investment advisers. This training program covered topics in Tasks 2 & 3.

  Deliverable: A one-week program offered each fall at the SEC for regulatory officials from emerging and developed markets. The SEC invited 4 regulators from the SEBI and the exchanges to the 2001 Institute.

  Counterpart: SEBI and the exchanges

  Target Date: The week of October 15, 2001.

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Status/Comments: The SEC invited 4 regulators from the SEBI and the two major exchanges. Three persons from the SEBI and one person from the NSE attended the International Institute for Enforcement and Market Oversight.

- **Capital Market Training Program in India**

Task: A one-week training program that will cover topics in each of the four tasks, including disclosure, rulemaking, regulatory oversight, inspections of SROs and market participants, enforcement and investor education.

Deliverable: A one-week capital training program in India for approximately 60 Indian securities regulators and market professionals.

Counterpart: SEBI, SROs (exchanges, depositories, member associations) and market professionals.

Target Date: 2nd Quarter, 2002.

Status/Comments: The SEC plans to conduct this training in May or June 2002.

- **International Institute for Securities Market Development**

Task: This institute is designed for senior regulators and stock exchange officials and is intended to promote market development, capital formation, and the building of sound regulatory structures in emerging market countries. This training program will cover topics in each of the four tasks.

Deliverable: An intensive two-week program of lectures, panels and workshops held each spring at the SEC and an optional internship with various market entities the week following the institute. The SEC plans to invite 4 regulators from the SEBI and one person from the BSE and one person from the NSE to the 2002 Institute.

Counterpart: SEBI and stock exchanges

Target Date: 2nd Quarter, 2002

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Status/Comments: The International Institute For Securities Market Development will be held in Washington on April 22-May 3, 2002.

- **Review of the Legal Structure for Securities Regulation**

Task: This technical assistance project will review the legal structure in India for securities regulation as covered in Task 1.

Deliverables:

- An appendix, drafted by Arthur Laby, to the World Bank mission report addressing governance issues at the SEBI, including issues related to SEBI's independence, authority, and use of discretion.
- A final Work Plan.
- A general report assessing the technical assistance and training needs to effectively regulate India's securities market.

Counterpart: SEBI

Target Dates:

- The target date for delivery of the draft appendix is October 2001.
- The target date for the Work Program is October 2001.
- The target date for the general report assessing the technical assistance and training needs to effectively regulate India's securities market is November 2001.

Status/Comments: This technical assistance project stated in June 2001 with a visit to India by Arthur Laby, an Assistant General Counsel at the SEC, as part of a World Bank team to assess India's capital market and regulatory structure. Attached is a copy of the draft report.

Ester Saverson visited India from September 18-29, 2001 to review the technical assistance and training needs. Subsequently, Mr. Saverson wrote a report assessing the technical assistance and training needs of the Indian Capital Market. A copy of the report was attached to the 1st quarter 2002 report.

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Mr. Saverson met with USAID/India officials and with officials of the private consultants to this project, PWC, in India to discuss the draft Work Plan. The SEC submitted a final work plan at the end of September 2002.

- **Assessment of Market Regulation**

  Task: This technical assistant project covers the SEBI's rulemaking process, SRO oversight and broker-dealer regulations in Task 2.

  Deliverable: A report assessing the SEBI's rulemaking process, SRO oversight and broker-dealer regulations.

  Counterpart: SEBI

  Target Date: June 2002

  Status/Comments: After making an assessment of the types of technical assistance and training needed, the SEC decided to revise the target date to the 2nd quarter, 2002. The SEC has also move up the target date for the review and training of SRO and broker-dealer inspection programs.

- **Workshop on Disclosure and Financial Reporting Standards**

  Task: This workshop will cover disclosure and financial reporting standards (including initial public offerings and continuing disclosure obligations of public companies) in Task 4.

  Deliverable: A workshop jointly conducted by the SEC and the contractor on disclosure and financial reporting standards.

  Counterpart: SEBI

  Target Date: The target date for the workshop on disclosure and financial reporting standards in India is November/December 2001.

  Status/Comments: The workshop will cover existing disclosure and reporting standards in India and U.S. and International disclosure and reporting standards. The SEC will contribute one person to help conduct this workshop.

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The staffs of the SEC and PWC were unable to coordinate their schedules during the November/December target date. The SEC and the PWC are in the process of rescheduling this training program.

- **Workshop on Investigation and Enforcement Procedures**

Task: This workshop will train SEBI and SRO officials in investigation and enforcement procedures in Task 3.

Deliverable: A three-day program in India to train the investigation and enforcement staff at the SEBI in practical techniques for conducting investigations.

Counterpart: SEBI

Target Date: November/December 2001

Status/Comments: This SEC and the contractor will jointly conduct this workshop. The SEC will contribute one person to help conduct this workshop.

The staffs of the SEC and PWC were unable to coordinate their schedules during the November/December target date. The SEC and the PWC are in the process of rescheduling this training program.

- **Assessment of Inspection Procedures for SROs and Broker-Dealers**

Task: This technical assistant project covers the SEBI's inspection procedures for SROs and broker-dealers in Task 2.

Deliverables:

- A report assessing the SEBI's inspection procedures for SROs and broker-dealers.
- A four-day program in India to train the inspection staff at the SEBI about inspecting SROs and the inspection staff at the SEBI and the SROs about inspecting broker-dealers.

Counterpart: SEBI

Target Date: First or Second Quarter 2002

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Status/Comments: The SEC staff is currently reviewing the manual used to inspect exchanges and the manual used to inspect broker-dealers. The SEC expects to issuer reports on its assessment of the two manuals in March or April 2002.

The SEC plans to conduct a workshop based on its finding from its review in May 2002.

- **Training on the Role of SROs in Regulating the Securities Market**

  Task: The contractor plans to bring a group of SEBI and SRO Officials to the U.S. for training on the proper regulatory structure and role of SROs in Task2.

  Deliverables: Provide instruction on the regulatory structure needed to provide oversight by the government regulatory of SROs.

  Counterpart: SEBI

  Target Date: First Quarter 2002

  Status/Comments: The SEC will work with the contractor to provide this training.

- **Video Conference Training Program**

  Task: This was not part of the original work plan. The SEC offered this training program with the use of the facilities at the World Bank.

  Deliverables: The SEC conducted a video conference training program covering insider trading and internet fraud. The conference was transmitted to participants in Russia, India, Mexico and Brazil.

  Counterpart: SEBI

  Target Date: December 6, 2001

  Status/Comments: Approximately 30 persons from India participated in the conference.

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Training

The SEC has provided access to 14 person weeks of training and the officials from India has participated in 9 person weeks of training. The SEC has offered and Indian officials have participated in 4 person weeks of training in the United States. The SEC has provided 6 person weeks of training and Indian officials have participated in 3 person weeks of training in India. The SEC has offered 4 person weeks of other training to Indian officials and they have participated in 2 person weeks of such training.

SEC Staff Time

Task Description	LOE (person months)*
1. SEBI's Capacity for Rule-making, Regulatory oversight and Inspection	0.5
2. SEBI's Capacity for Investigation and Enforcement	1
3. Disclosure and Reporting Standards	0
4. Legal and Institutional Framework for Investor Protection	0.5
TOTAL	**2**

* "LOE" is the level of effort to date that the SEC staff has spent on each task.

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INDIA

July 2001

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Annex 1: History of Market Conduct: Equity market crises in India in the decade of the 1990s

I. Background and Introduction

The Indian equity market presents a paradoxical picture in the decade of the 1990s. On the one hand, profound changes took place in terms of institutional development, in the form of:

- NSE, a professionally run stock exchange, which was a highly successful change agent which brought forces of innovation and competition into the securities industry,
- NSCC, the central counterparty which first addressed the problems of settlement risk in India in a serious way,
- NSDL, the first modern implementation of a securities depository in India.

These three institutions are important achievements of institution-building. Put together, they have revolutionised the Indian equity market (Shah&Thomas2000, Shah&Sivakumar2000, Shah1999, Shah&Thomas1997).

At the same time, the decade of the 1990s was marred by a series of stock market crises. These crises made the front pages of newspapers, and have played an important role in conveying an image of disarray and fraud when uninformed households in India think about the stock market.

A central feature of these crises was the incidence of market manipulation on the secondary market. In understanding policy issues connected with securities markets, it is important to better understand these episodes, and learn from them. This paper seeks to offer some insights in these directions. It is necessarily a tentative and incomplete account, since most facts about these episodes are not publicly known. However, we try to utilise publicly available information in order to piece together an account of these events and their consequences for public policy.

The rest of this paper is organised as follows. First, in Section 2, we offer a broad description about how market manipulation appears to take place on the secondary market, with a focus on the role of the different economic agents. In Section 3 we summarise the major crises which took place in the 1990s.

The fixed income and stock market scandal of 1991 and 1992 caused the biggest stock market bubble in the Indian equity market in the last decade. This crisis has been documented in detail in a 1993 RBI Committee report, the "Janakiraman report" and a book published by the journalists whose stories helped break the bubble, Sucheta Dalal and Debashis Basu (Basu&Dalal1993). Hence, we focus on four of the other important crises, in Section 4 (the M. S. Shoes scandal in 1995), Section 5 (the CRB group in

1997), Section 6 (BPL, Sterlite and Videocon in 1998) and Section 7 (Ketan Parekh in 1999-2001).

Finally, in Section 8, we try to draw some lessons from these episodes, delineate the areas where improvements in market infrastructure and regulation have substantially addressed the vulnerabilities exploited in these episodes, and the areas for concern in the future.

II. How market manipulation takes place

Prices can be said to be manipulated when the level of prices is kept artificially higher or lower than the "fair price"' through the actions of a small cartel. Price manipulation on the secondary market is very difficult to detect. This is because there are no sound models which can accurately predict the "fair value" of the shares of a company. The prices on the market fluctuate due to flows of information, either pertaining to the economy or specific to the stock. It is difficult to differentiate price fluctuations owing to fundamental factors as opposed to price changes driven by a manipulator.

In India, the manner in which price manipulation is done seems to generally involve collusion on the part of four kinds of economic agents: (a) securities industry professionals, (b) dominant shareholders of the listed firm, (c) fund managers and (d) journalists. It is useful to explore the rational decisions that flow from profit maximisation on the part of each of these economic agents.

The broad strategy of market manipulation is to deploy capital into buying (or selling) shares of a target company. If sufficient capital is deployed in this, the price would rise (or fall). At some point, the manipulative cartel hopes to close out its positions and earn a profit.

A. Securities industry professionals

A critical component of a manipulative effort are securities industry professionals who have access to the stock market and are close to the order flow. They are typically stock brokers, although that does not have to always be the case. Through them, the cartel deploys capital into building large positions on a stock and drives up its price. Brokers are often approached for investment advice by clients, both retail and institutional. This service becomes one more avenue through which the broker can access capital, which is deployed into buying shares of the target firm.

B. Dominant shareholders of the target firm

The dominant shareholders of the target firm can be an important partner to a manipulative cartel, through the following ways:

- The dominant shareholders control the target firm, and the target firm can lend to the manipulative cartel. This source of funds is important because the typical large firm can access vastly larger financial capital as compared with the typical securities firm.

- They can collude with the cartel by making decisions which impact on the floating stock. Prior to dematerialised settlement at the depository, they could temporarily block share transfers, thus reducing the floating stock in the market. This was an important feature of the past; however it is irrelevant today given that transfers take place at NSDL. More importantly, firm insiders are well equipped to make judgments about when their share price is overvalued. If they choose to sell shares at this time, it would severely hinder a manipulative effort. It is important for the cartel to have the cooperation of the dominant shareholders of the firm, so that this selling will not take place.
- Lastly, the firm can release stories to the media that make the price movement plausible, and encourage buying by investors unrelated to the cartel. This can be in the form of rumours in the market, or in the form of stories leaked to the press. Stories in the newspapers can be timed to coincide with the cartel's position building in order to achieve a higher price impact.

C. Mechanisms for obtaining leverage

Given a stock of capital, the manipulative cartel can maximise the size of orders on the market by exploiting every mechanism available to leverage their positions. In the decade of the 1990s, there were several features of the spot market which supported leveraged trading:

- The basic spot market operated like a futures market, with account period settlement instead of rolling settlement.
- The differences in the settlement cycle between NSE, BSE, etc. allowed for positions to be carried forward without settlement.
- BSE's *badla* was explicitly a mechanism for carrying positions forward without doing settlement.

NSE's *albm* also became similar to *badla*.

Futures style settlement

Through the 1990s, India's equity market operated like a futures market. For example, on NSE, trading took place from Wednesday till Tuesday. Trades were netted through the week, and Tuesday was the expiration date. Open positions of Tuesday evening were settled on a T+5 basis.[1] This made it possible to take leveraged positions within the settlement cycle, as with a futures market.

Differences in the settlement cycle periods

Futures--style settlement, by itself, yields leverage until expiration date. Positions held on expiration date are required to settle in full.

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[1] Equity trading started on NSE in 1994 with the trading cycle shortened to one week. The BSE followed suit in 1995. Prior to this, the netting period was a fortnight or more.

In India, differences in the trading cycle across different exchanges made it possible for traders to indefinitely obtain leverage. For example, NSE had a settlement period which ran from Wednesday to Tuesday, while BSE had a settlement period which ran from Monday to Friday. Brokers would close positions on Tuesday on the NSE, and open them on the BSE. On Friday, they would close these positions on the BSE and open them on the NSE.

As long as the exchanges had different settlement cycles, brokers could trade a position indefinitely. The cost they would pay was the transactions cost of closing out positions on one exchange and opening it on the other.

Carry forward mechanism

Exchanges provided their own market mechanism to enable brokers to carry the positions forward beyond the settlement period cycle. The most popular of these was *badla*. At the end of trading in a settlement period (Friday for the BSE), a separate market would be run on the next day (Saturday).

For a given stock, the longs could sell off their obligations to buy securities at T+5 in the *badla* market. This could be to either financiers who would bring funds to take delivery at T+5, or to the shorts. The exchange would record these transactions, and the rate at which the transactions took place, called the *badla* rate. At the start of trading of the normal market, the exchange would automatically re--open the *badla* positions for the long and the short respectively. Therefore, brokers could carry forward their positions indefinitely at the cost of paying the *badla* rate every week.

Many considered *badla* to be a stock lending and money lending scheme. The key difference was that the entire long or short position was not funded using external financiers or lenders of shares, as is the case in stock-lending and money-lending schemes. With *badla*, at an essential level, the longs were netted against the shorts. This led to many strange outcomes. For example, at each *badla* session, either the longs or the shorts got paid for borrowing. Similarly, the open interest under *badla* could be larger than the market capitalisation of the company. The open interest under *badla* was certainly larger than the floating stock on many occasions. These situations were exploited by manipulative cartels in creating short squeezes.

Lax enforcement of margin requirements

In each of the mechanisms described above, the leverage of the positions are limited by the margins collected to manage the risk of the positions. If the margin collection was lax and not enforced, the leverage of the position was enhanced. This was often the case with the broker--run exchanges, where the enforcement ran into problems of agency conflicts between the adminstrators (who were brokers) and the regulated brokers. In the early nineties, margins payments could easily be delayed by a broker with the right connections. After 1998, it appears that margin enforcement at the BSE improved substantially. However, poor enforcement of margin collection was central to the CSE payments crisis in 2001.

D. Fund managers

Fund managers are important to a manipulative cartel in two ways:

1. The large resources of a fund manager can be deployed into the manipulative effort, if the fund manager can be persuaded to buy shares alongside the cartel.

Similarly, a fund manager can own the shares of a company targeted by a manipulative cartel. If the fund manager sees that prices have risen above fundamental value, and sells shares on the market, it could be a severe setback to a manipulative cartel. So, successful manipulative cartels seek to identify important possible sources of selling into the market and co-opt them into the manipulative efforts.

2. At the end of a manipulative effort, when the cartel needs to close out positions and exit, it is very efficient to do large OTC transactions where the position is sold to institutional investors. At this step, the fund manager who cooperates with a manipulative cartel is making a decision which is against the interests of good portfolio returns.[2]

It is hard to explain such behaviour without focusing on the agency conflicts between individuals employed at an asset management company, and the interests of their investors. Ideally, such actions should be held in check by performance evaluation procedures which penalise funds which obtain poor returns. However, the signal to noise ratio in fund performance evaluation is poor (Shah&Fernandes2001). In India, there is as yet no service which uses sound financial economics in measuring the risk-adjusted return of funds.

III. Major market crises

In the previous section, we described how stock price manipulation has allegedly taken place in India over the last decade. Next, we list the major market crisis that have taken place in Indian equity markets in the last decade. In each case, we briefly describe the episode and try to quantify the losses that were involved in each episode. We also try to describe briefly what regulatory changes were instituted after each episode, if any.

A. 1992: Harshad Mehta

The first "stock market scam" was one which involved both the debt and equity markets in India. The manipulation was based on the inefficiencies in the settlement systems in debt market transactions. Money that was meant to pay for transactions in debt market trades, was delayed in transit. During that short period of time, it was instead lent out by

[2] If this strategy was indeed employed often, it would imply that fund managers in India "often" buy stocks at the height of a manipulative episode, and would see the NAV of their portfolio degrade in value when the price reverted to fundamental value. However, this is difficult to prove, since the same symptoms could be obtained out of mere positive feedback trading on the part of a fund manager with a poor knowledge of financial economics.

banks to brokers, for higher returns from investing in the equity market. The most prominent stockbroker who exploited these loopholes Harshad Mehta. Mehta used these funds to manipulate prices on the stock market.

The banks had extremely weak risk management, and were extremely vulnerable to settlement risk. This meant that Mehta had access to practically unlimited amount of capital for price manipulation, which he further leveraged using the market mechanisms described in the previous section. This created a price bubble in the equity markets, where the market index went up by 143\% between September 1991 and April 1992.

The bubble burst when banks and brokers started getting investigated in April 1992 following a newspaper story, which appeared in *The Times of India* on 23 April 1992. This story reported on inconsistencies between the transaction records at the State Bank of India (SBI) and corresponding records at the RBI, and blamed irregularities in trading and surveillance of trades at banks for the gap.

The amount involved in this crisis was approximately Rs. 54 billion. This scam gave rise to the equity market reforms that began in 1992.

B. 1994: M. S. Shoes

India had restrictions on pricing of new issues up to 1992, after which the Controller of Capital Issues (CCI) was abolished. After this, primary market offerings were priced without interference of government regulations. This was a period where firms and investors were learning this new institutional environment. The first four years also had a series of episodes of price manipulation surrounding new issues of shares.

The most spectacular of these episodes involved *M.S.Shoes (East) Ltd.* Here the dominant shareholder of the firm, Pawan Sachdeva, took large leveraged positions through brokers at both the Delhi and Bombay stock exchanges, to push up share prices prior to a rights issue. When the share prices crashed, the broker defaulted and BSE shut down for three days as a consequence. The amount involved in the default was Rs. 170 million.

After this episode, the BSE settlement cycle shifted to seven days, in keeping with what was then prevalent on the NSE. SEBI became more stringent in it's supervision of issues. It is interesting to note that while this was not the last payments crisis on the BSE, it was the last event where trading on the BSE actually closed down while a payments crisis was resolved. We examine details of this episode later in the paper.

C. 1995: Sesa Goa

Another episode of market crisis for the BSE, was the case of price manipulation of the shares of *Sesa Goa*. This was caused by two brokers, who later failed on their margin payments on leveraged positions in the shares.

The exposure was around Rs. 45 million. At the end of this episode, the BSE raised the margins on all stocks. They created B1 and B2 group of stocks where the margins on the B2 stocks was much larger than that on the B1.

D. 1995: Rupangi Impex and Magan Industries Ltd.

The prices of *Rupangi Impex Ltd.* (RIL) was manipulated in October 1995 and *Magan Industries Ltd.* (MIL) in January 1996. In both cases, the dominant shareholders implemented a short--squeeze. In both cases, the dominant shareholders were found to be guilty of price manipulation.

Both these cases started with unusually large rises in the price of the shares. The prices of MIL rose from Rs.16.50 in December 1995 to Rs.180 in January, 1996 (900\%) in 18 days. This was noticed by the exchange (BSE) which suspended trading in the shares four times. The RIL manipulation episode began after a public issue in December 1994, at Rs.101.25. By October 1995, the shares were trading at Rs.692 (583\%). Trading in both shares was suspended indefinitely at the exchanges because of these sharp price rises. Simultaneously, SEBI started investigations into the trading of these shares.

When trading got suspended, the exchanges auctioned the positions and found a large short position with no delivery. The exchanges auctioned off the short positions at a second auction, for which the price is set by certain well--defined rules. Dominant shareholders were persuaded by the exchange to sell shares at this auction at a higher price. Later, SEBI investigations uncovered that the dominant shareholders had colluded with other brokers in circular trading that pushed up the price of the stock in the period immediately prior to the auction. In these two episodes, the dominant shareholder manipulated the price of the shares in a manner to take advantage of exchange auction rules.

The amounts involved were Rs.5.8 million in the case of MIL at the BSE, and Rs.11 million the case of RIL at the NSE. SEBI issued a directive that withheld the proceeds of the auction from the dominant shareholder.

E. 1995: Bad deliveries of physical certificates

When anonymous trading and nation-wide settlement became the norm by the end of 1995, there was an increasing incidence of fraudulent shares being delivered into the market. It has been estimated that the expected cost of encountering fake certificates in equity settlement in India at the time was as high as 1\% (Shah&Thomas1997).

This raised the urgency on pushing the Depository Act and encouraged the trading of dematerialised shares.

F. 1997: CRB

C. R. Bhansali created a group of companies, called the CRB group, which was a conglomerate of finance and non-finance companies. Market manipulation was an important focus of the activities of the group. The non--finance companies routed funds to the finance companies to manipulate prices. The finance companies would source funds from external sources, using manipulated performance numbers. The CRB episode was particularly important in the way it exposed extreme failures of supervision on the part of RBI and SEBI.

The amount involved in the CRB episode was Rs.7 billion. We detail this episode later in this paper.

G. 1998: BPL, Videocon and Sterlite

This is an episode of market manipulation involving the broker that engineered the stock market bubble of 1992, Harshad Mehta. Headopted positions on a set of stocks called "Harshad stocks" to manipulate the share prices. He did this in collusion with the management of the companies, while obtaining leverage through the methods detailed in Section 2. The episode came to an end when the market crashed due to a major index fall, and Mehta did not find the liquidity to maintain his leveraged positions.

In this episode, the top management of the BSE resorted to tampering with records in the trading system in trying to avert a payments crisis. The President, Executive Director, and Vice President of the BSE had to resign due to this episode. This episode also highlighted the failure of supervision on the part of SEBI.

The amount involved in this episode was Rs.0.77 billion.

H. 2001: Ketan Parekh

The most recent episode of a market crisis. Our knowledge of the modus operandi of this episode is the weakest, since investigations are still under way. This was triggered off by a fall in the prices of IT stocks globally. Ketan Parekh was seen to be the leader of this episode, with leveraged positions on a set of stocks called the "K10 stocks". There are allegations of fraud in this crisis with respect to an illegal *badla* market at the Calcutta Stock Exchange and banking fraud.

While these crises enjoyed considerable contemporary media attention, there is a gap in the literature in terms of the availability of economic history addressing these crises. Ideally, a comprehensive history of financial scandal in India in the 1990s needs to be written. However, in this paper, we deal with the more limited goal of describing four important crises:

1. 1995 -- M. S. Shoes
2. 1997 -- The CRB crisis
3. 1998 -- BPL, Videocon, Sterlite
4. 2001 -- Ketan Parekh

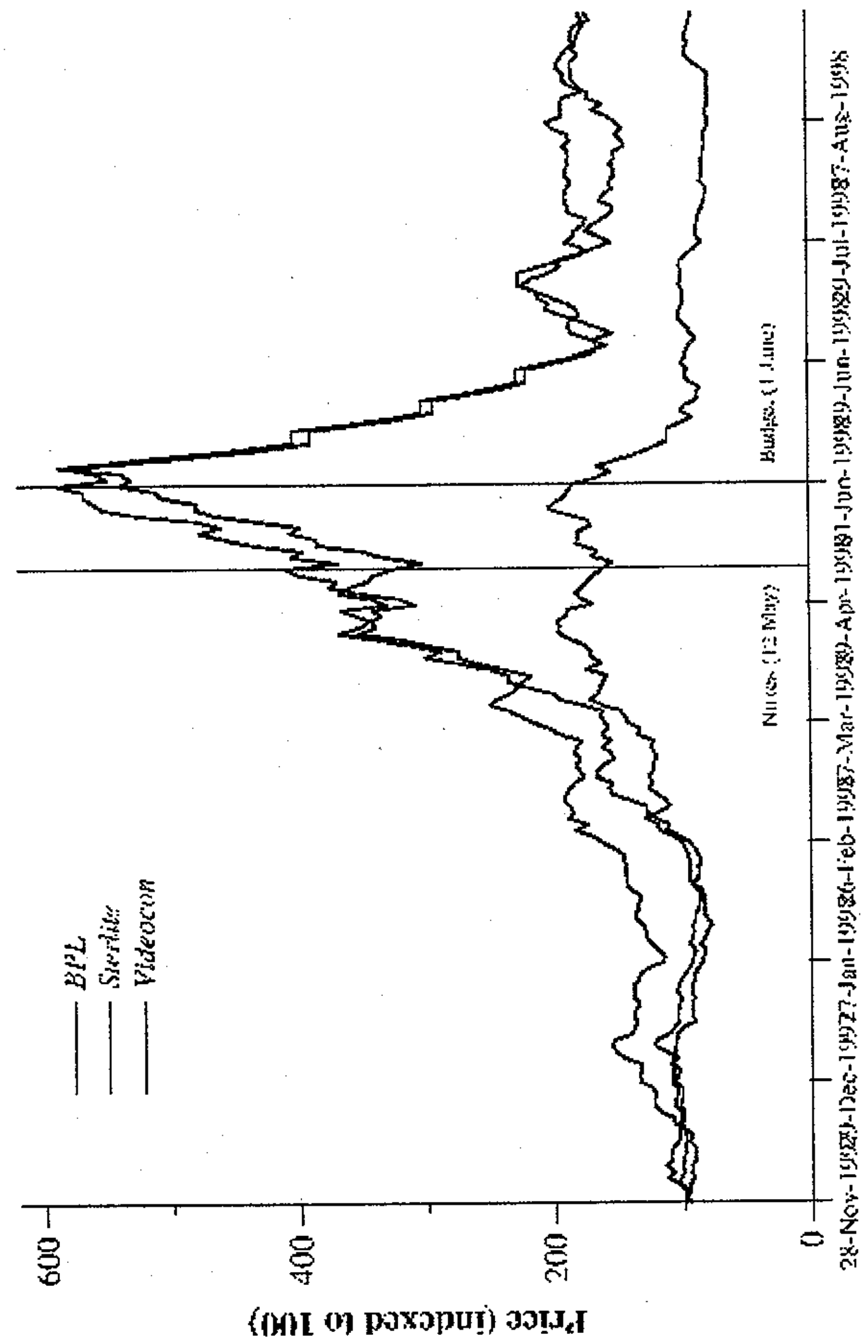
IV. Crisis 1995: M. S. Shoes

The crisis surrounding M. S. Shoes (East) Ltd. (MSSEL) is particularly interesting because it was the last time that trading on the BSE closed down for three days. At the time, NSE was not yet a liquid market, and the event of the BSE closing down for three days was highly significant for India's economy. For example, newspapers reported that it led to a loss of confidence amongst foreign investors about robustness of market mechanisms, and a fall in prices of Indian products listed on the GDR market.

There were three important facets to the M. S. Shoes crisis:

- Irregularities in a joint primary market placement of a rights issue and a SEO,
- Market manipulation on the secondary market,
- Poor management of settlement risk at the BSE.

FIGURE 1: Time series of price of M. S. Shoes (East) Ltd., March 1993--Dec 1995



MSSEL was headquartered in Delhi, and the CEO was Pawan Sachdeva. The firm intended to do an SEO and a rights issue in February 1995. To help improve the offer price at these primary market offerings, it appears that Mr. Sachdeva placed orders with a stock broker located in Delhi (Sareen & Co.) to buy shares of MSSEL. These orders were routed to the BSE (the dominant market at the time) through a BSE member named R. S. Jhaveri. In this way, it appears that 250,000 shares were purchased between December 1994 and January 1995, when the prices were between Rs.400 and Rs.500 (See Figure 1). It is useful to compare the modest size of the funds deployed into these purchases (Rs.110 million) with the enormously larger funds which would have accrued to MSSEL if the rights issue and the SEO had gone through (Rs.6.9 billion).

It is conceivable that if MSSEL's malpractices had been limited to market manipulation, then the crisis might have never taken place and MSSEL might have got away with it. Instead, the firm also engaged in dubious practices on the primary market. There were several aspects where MSSEL's primary market offerings violated existing regulations:

- The prospectus did not mention that the issue price of Rs.199 was ex--rights. In comparison with the market price of Rs.500, this appeared exceptionally attractive.
- The gap between the rights issue and the public issue violated a SEBI regulation.
- The company was permitted to collect 50% of the application money at subscription date, rather than 20%, which was the norm.

These violations took place even though MSSEL's investment banker was the largest investment banker in India (SBI Capital). These documents were also cleared by SEBI. In early February, Dr. L. C. Gupta, who was then board member of SEBI, went to the press with a criticism of some of the violations of the MSSEL primary market offerings. This created a controversy about these dubious practices, and on 7 February 1995, SEBI asked MSSEL to correct these announcements. The primary market offerings opened on 14 February after advertisements were placed with corrections.

On 18 February, announcements were made that the primary market offerings were 90% subscribed on the market. Information revealed later shows that 63% of the funds were actually paid by Mr. Sachdeva and his associates, and that one of the large cheques presented here actually bounced.

On 17 March, the BSE postponed a payout because of the failure of R. S. Jhaveri to make payments of Rs.110 million or so. The payout was delayed by a week to accomodate Mr. Jhaveri. It appeared that Mr. Sachdeva had defaulted on payments to Sareen & Co., which had (in turn) defaulted on payments to R. S. Jhaveri. BSE did not hold adequate margins which would protect the settlement system against such a small failure.

Trading on BSE was halted on 20, 21 and 22 March while the exchange administration tried to work out a compromise through which the payments problems could be resolved.

A. Regulatory reactions

The CBI arrested Pawan Sachdeva on 9 April. He was charged for cheating, breach of trust and abuse of authority under the provisions of the Indian Penal Code (IPC) and the

Prevention of Corruption Act. The CBI later filed a complaint against Sachdeva under the Companies Act for fraudulently inducing investors to invest money. This was primarily about the information in TV advertisements prior to the public issue and the MOU signed between MSSEL and SBI Caps.

On 25 March, SEBI issued a showcause against MSSEL on the grounds that it bought its own shares.

MSSEL filed a case against SBI Capital for reneging on its underwriting commitments.[3] Other than this, there was no action brought against SBI Capital for the violations of guidelines embedded in the MSSEL prospectus. In January, 1998, SEBI finally took action against Sareen & Co., banning them from trading for a year.

V. Crisis 1997: CRB mutual fund

C. R. Bhansali created a group of companies between 1992 and 1995. One component of the scam were financial sector companies, which included the flagship company which was an NBFC and merchant banker, CRB Capital Market; financial services companies for share transfer, share broking, custodial services which included CRB Corporation and CRB Share Custodial Services; and lastly, in 1995, a mutual fund which was CRB Mutual Fund. The second component included companies that wanted raise funds from the market.

The financial sector companies were used to raise funds in the form of deposits from investors and bonds that were issued to banks and financial institutions. The funds were then invested back into the firms within the group. Part of the funds were used to pay interest to depositors and redemption on prior bonds and issues. This Ponzi scheme had just under Rs. 10 billion under management.

This episode is an interesting example to analyse market integrity, in the role played by the financial market regulators. The regulators were not alert to the linkages between these companies, despite several instances when they should have been more carefully examined. For example:

- The RBI gave the group "in--principle permission" to start a bank, after they applied for a licence in 1994. This was cancelled only in December, 1996, when the RBI found problems in the groups fixed deposits programmes.
- SEBI had documentary evidence from auditors of problems with the scheme started by the CRB Mutual Fund. These reports were from external auditors in December, 1994 and December, 1996, as well as reports from SEBI's internal staff in August, 1995. Nevertheless, the mutual fund was approved to sell their schemes.
- As a result of the favourable responses of the two regulators towards CRB Capital Markets, CARE, a credit rating agency, gave them an A+ rating in February 1994.

[3] The underwriting amount was Rs.150 million.

Three months after the CRB scam broke, the ratings of nearly 60 NBFCs were lowered.

Each of these instances were clearly situations where a careful examination of the company should have triggered suspicion. Yet it did not. These instances, at best, showed poor information processing by the regulators, or biased decision making, at worst.

The CRB scam broke in April 1997 when CRB Caps encashed some warrants to pay interest and redemptions to investors at the State Bank of India, and later defaulted on interest payments. This default set off a series of investigations into the company, which then uncovered the crossholdings of and payments network within the whole group. The episode ended with C R Bhansali leaving the country and being arrested by the CBI while in HongKong. At this time, the liabilities by the CRB group were Rs.1.3 billion to banks, Rs.60 million to UTI, Rs.1.2 billion to the Gujarat government, Rs.1 billion to companies, Rs.1.8 billion to individual depositors and Rs.2.3 billion to the mutual fund holders.

A. Regulatory reactions

This episode did a lot of damage to the reputation and integrity of the regulators. In addition to the cases against C R Bhansali, and some SBI bank officials, the anti--corruption branch of the CBI started a preliminary enquiry against the SEBI officer in charge of mutual funds. A prominent business magazine, *Business India* carried a cover story titled *Was D. R. Mehta too kind to CRB?,* documenting the links between the SEBI chairman and CRB. However, no action was taken against any RBI or SEBI officials.

The damage--control responses by the regulators to the CRB episode were:

- The RBI immediately made the registration of NBFCs mandatory.
- The RBI put the "weakest 10 NBFCs" under strict investigations and supervision.
- The RBI Act was amended to allow them sweeping powers to register and regulate NBFCs.
- SEBI brought mutual funds under much tighter regulations. This included prohibiting investments by the mutual funds into the sponsors own group by private placement or if the securities were unlisted; increasing the number of independant trustees on the board of the fund; standardisation of the offer document with proposed asset allocation and risk--return patterns, performance of previous schemes by the fund, etc.
- In August 1997, SEBI launched an insider--trading case against Hindustan Lever Ltd. (HLL) about a purchase of shares of Brooke Bond Ltd. at the time of the merger between HLL and Brooke Bond in March, 1996. This was viewed in the media at the time as an attempt at deflecting attention from the links between the SEBI chairman and CRB.

There was nothing by way of regulations that aimed to fix the problems of corporate governance, either at the level of the firms (who assisted the CRB group in order to manipulate their own share price) or at the level of the investment banker (whose lack of due diligence of the offer documents and the proceedings made them an accomplice to the misinformation of the public.)

VI. Crisis 1998: BPL, Videocon, Sterlite

The case of the price rigging of the BPL-Videocon-Sterlite (BVS) companies offers us an opportunity to ask if market reforms were indeed effective and what changes were yet to be implemented in the equity market. This was another situation of a broker and the firm colluding to manipulate share prices.

Harshad Mehta was back in the market after the 1992 crisis. His reputation from the previous crisis appears to have stood him in good stead, and helped him engineer the following crisis as well. There are a number of companies who appeared to have colluded with him to manipulate their own share prices. Of these, B. P. L. Ltd (BPL), Videocon International (Videocon), and Sterlite Ltd. (Sterlite) were those that rose to public prominence.

The modus operandi Mehta employed in 1998 was slightly different from his 1992 experience, or from the M. S. Shoes experience of 1995. All the exchanges were now anonymous limit order book markets that had expanded much beyond the geographical limits of Bombay. Mehta took advantage of this: instead of taking positions directly, trades on these stocks were put through seven front brokerage firms. These, in turn, dealt with 34 other firms. Through this network of brokers, he was able to manipulate the price of shares by building up large positions, while maintaining his anonymity.

The spreading of position taking through different brokers was also useful to hide the link between payments made by the firms to the brokers.[4] The firms would pay brokerage firms for shares bought by the brokers in ``negotiated deals", where there was no real transfer of shares involved. Another mode of transfer was in the form of loans and inter corporate deposits to brokers, which was then used by the broker to purchase shares. The shares were held in the custody of the broker, rather than the firm, to comply with the Companies Act.[5] In all cases, there was no apparent, direct link between the broker and the firm.[6]

Mehta used the Internet to also put out stock recommendations, and these were said to be eagerly watched by investors. They were certainly watched by the media. In an echo of

[4] This was in sharp contrast with the ease with which investigators on the M. S. Shoes case could make the links from Pawan Sachdeva, who placed all his orders with Sareen & Co only, which in turn placed orders with R. S. Jhaveri only.

[5] The act prohibits the purchase by a firm of its own shares on the secondary market.

[6] Sterlite Industries is said to have paid Rs.1.18 billion to purchase shares, disguised as a loan routed through a MALCO, a company associated with the brokerage firm, which was transacting in Sterlite shares. Videocon routed Rs.100 million through various transactions and bank accounts with it's associated firms to firms associated with the broker. Some of these transactions were negotiated deals where there were no real shares involved. According to the SEBI report done after the bubble burst, these false transactions were merely a cover for funds movement from firm to broker.

what would happen in 2001, there were a group of stocks that were marked as "Harshad stocks" in the media. These were stocks that started out small and illiquid.[7] The press had varying reports of the amount of Mehta's involvement in these shares: some claimed that he controlled 70% of the positions; others claimed that his positions were between 30-40% of the delivered volumes. These positions were usually switched from the BSE to the NSE and back again to avoid settlement. These large and concentrated positions should have alerted exchange officials to a possible manipulative attack on the share prices.

When investigations into this episode were going on, SEBI reported that between 3.0 and 3.5 million shares, out of the total 5 million traded in the market, were traded by the Mehta broker led group. The final positions were apparently accumulated over five to nine *badla* sessions.

Simultaneously, the companies also released public news reports that helped supported the price rise. These news releases later turned out to be false. Some examples were:

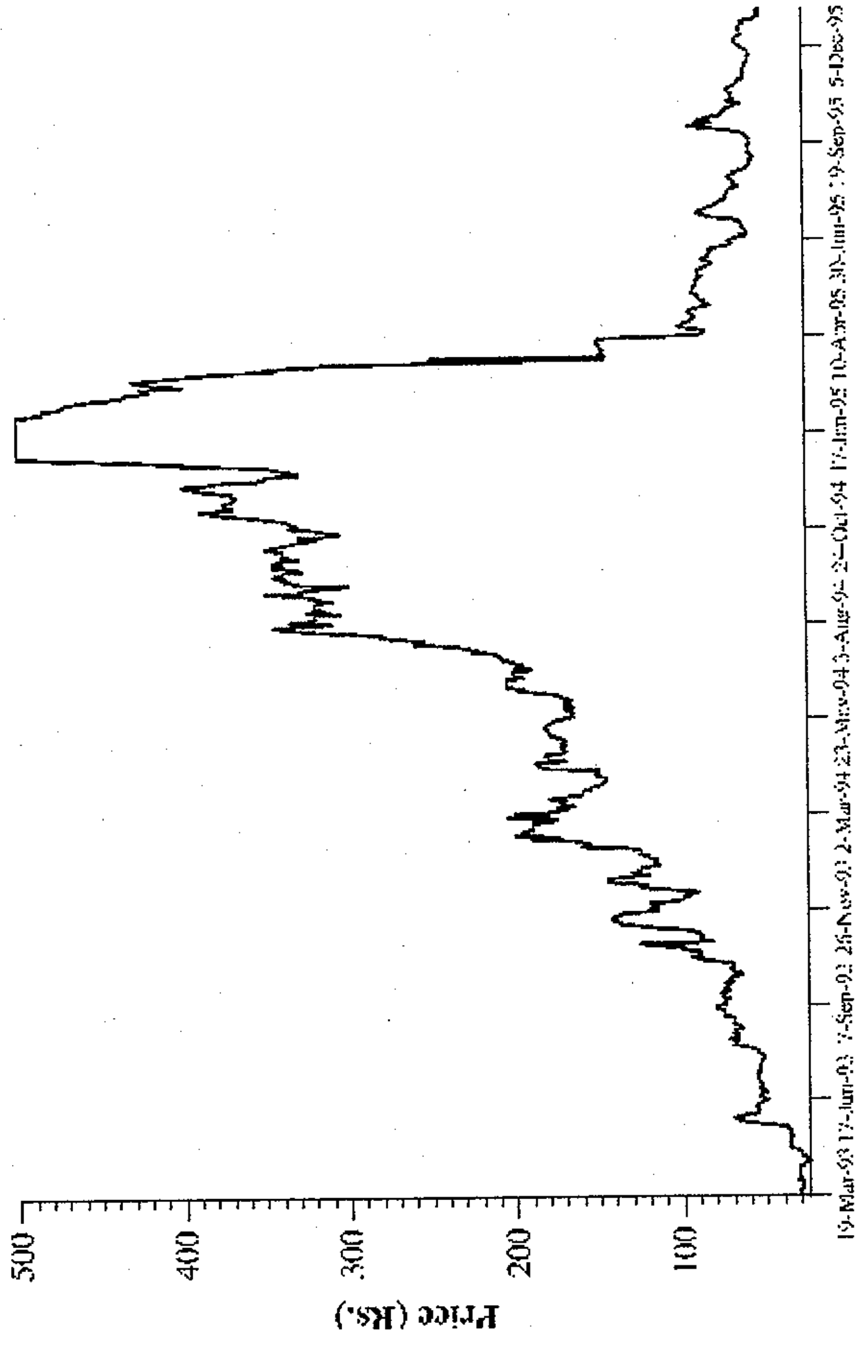
- Videocon chairman, V. N. Dhoot, announced that he was launching an open offer to buy 2% of the companies stake from shareholders.
- Zee Telefilms chairman, Subhash Chandra, made a similar announcement of the promoters preparing to buy 2% of the market shares to increase their stake in the company.

Neither case was followed by the promised action by the companies. In some cases, there was genuine news like the Sterlite attempt to take over Indal through an open offer in February 1998.

There was a significant impact on the prices of the BVS shares: BPL rose from Rs.100 in January 1998 to Rs.445 in June (345%), Videocon from Rs.25 to Rs.168 in the same period (572%), and Sterlite from Rs.162 to Rs.385 (138%) (as seen in Figure 2). Videocon also had a GDR trading, which went from $1.45 to $2.99 in the same period (83%).

FIGURE 2: Time series of price of BPL, Videocon International and Sterlite Industries, August 1997 to December 1998

[7] Newspapers reported that Mehta avoided stocks that had a large foreign institutional presence in trading.



At this time, there were two events that had a negative, macroeconomic impact. On 12 May, the government of India carried out a test of nuclear weapons in the deserts of Pokhran. This caused Nifty to drop from 1160 to 1094 in two days (5.6%). The next was the Budget announcement on 1 June, where Nifty dropped again from 1063 to 993.5 over five working days (6.5%).

The prices of the BVS shares started falling by the same day itself. The rate at which the prices fell was decreased by the 8% price limits that were in place. From 1 June to 30 June, BPL had fallen from Rs.409 to Rs.139 (-66%), Videocon from Rs.168 to Rs.51 (-70%) and Sterlite from Rs.169 to Rs.88 (-48%).

The brokers who had taken positions on behalf of Mehta started defaulting on their payment to the exchange. There were brokers both on the BSE and the NSE who were involved in the price rigging. The difference was that while the NSE rigidly enforced margin payments, the BSE was lax. This showed up when:

- The BSE apparently lowered margins on these stocks to reduce the pressure of margin payment on the brokers.
- Some of the concerned brokers apparently did not pay margins on the huge positions they held of the BVS shares.
- When the brokers were about to default with a possible liability of Rs.0.77 billion, the BSE arranged for a bailout.[8]

The bailout was effected at a price different from the much lower price prevailing on the exchange, and was implemented as off--market transactions. These transactions were entered into the exchanges trading computers in the middle of the night. The transactions were entered by the president of the BSE.

The BSE did not stop trading because of a payment crisis.

A. Regulatory reactions

- On 12 June, SEBI imposed additional margins on net short-sales positions to the tune of 50%.
- On 17 June, SEBI imposed a ban on short sales.
- On 6 July, SEBI announced the intent to introduce stringent measures for reporting and exposure of negotiated deals.[9] All negotiated deals had to be exposed to the market for 10 minutes, and had to be reported to the exchange within 15 minutes of trading.
- In Sep 1998, after the story about the tampering of the exchange trading system in the night appeared in the newspapers, SEBI immediately suspended 17 brokers --

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[8] Details for the bailout of each of BPL (http://www.rediff.com/money/2001/apr/24dalal.htm), Videocon and Sterlite was reported in the media by Sucheta Dalal in 1998. The SEBI investigations into the malpractices at the BSE were intiated after this. Her reports were validated when SEBI announced the results of its investigations in 1999. Interestingly, it was Sucheta Dalal who was the reporter for the Times of India who broke the story of the price manipulation by Harshad Mehta in 1992, as well.

[9] It was announced that any transaction for a volume of 100,000 shares or more would be construed as a negotiated deal.

10 on the BSE, 7 on the NSE. They were suspended for periods between one to three years.

One of the firms that was debarred from trading belonged to Rajendra Banthia, who was the vice-president of the BSE and a director on the BSE board. At the time, there were exchange bye-laws and SEBI norms that prohibited a member whose trading rights had been suspended from holding a post of a director at a stock exchange. This was reported in the newspaper, but Banthia remained on the board until November, 1998.

- In February 1999, SEBI issued show cause notices to the BSE President J C Parekh, Executive Director R C Mathur and vice-president, Rajendra Banthia. SEBI issued similar notices to the NSE.
- The president of the BSE, JCParekh, was asked to resign on 24 March 1999.
- The BSE executive director, R. C. Mathur resigned on 24 April 1999.
- In April 2001, Harshad Mehta was permanently barred from dealing in the stock market.
- The April 2001 ruling also banned BPL from sourcing funds from the "capital market" for four years. Five directors are being prosecuted.

Videocon International has been banned from sourcing funds for three years; three of its directors are being prosecuted.

Sterlite has been banned from sourcing funds for two years; three directors are being prosecuted.

This is another episode that showed the regulator in poor light.[10] The alacrity with which the 17 broker firms were banned after the press stories of the malpractices at the BSE could point to the fact that SEBI was either (a) aware of who was involved in the price rigging episodes, and had chosen to ignore it, or (b) that the 17 broker firms were chosen, without substantive cause, to show that SEBI was actively punishing wrong--doers.

The final interesting point of comparison in this episode is the difference in the governance at the two largest exchanges, NSE and BSE. The NSE was able to control the risk of broker defaults through a robust marginning mechanism that was also enforced. We could also argue that this episode showcases how some of the actions taken at the BSE was less likely to happen at the NSE because of the lack of agency conflicts for an exchange management who are not broker members.

VII. Crisis 2001: Ketan Parekh

Information available in the public domain about the recent stock market crisis is relatively limited. The broad outline of the events may be described as follows.

[10] Like in the case of the CRB mutual fund crisis, SEBI was seen to ignore the lax risk management practices at the BSE, despite signals like annualised interest rates of 165% and 182% on BPL and Videocon in the badla market.

In 1997 or 1998, a relatively small stockbroker named Ketan Parekh embarked on large leveraged positions on a set of IT stocks. The names of these stocks are believed to be known to the mass media, where they are called the "K-10" stocks.[11] When these positions were first adopted, these stocks were fairly illiquid, with a small floating stock.

There is some evidence that there was a nexus between these firms and Ketan Parekh and associates. For example, we have concrete evidence that two firms[12] gave short-term loans to Ketan Parekh. These resources could have been deployed back into taking leveraged positions on these stocks. It is widely believed that the extent of leverage present in the positions was significantly magnified by exploiting an illegal *badla* market associated with the Calcutta Stock Exchange.

Ketan Parekh and his associates also did extensive business with a set of banks. There is evidence of several aspects of these relationships: (a) They held a significant shareholding in some banks, (b) The banks supplied loans against shares and bank guarantees.

From 1997 to 2000, there were sharp increases in the prices of IT stocks in the Indian market, partly reflecting global valuations of these stocks. This generated extremely large profits on these leveraged positions. These profits could (in principle) have fed back into further large leveraged positions.

Over these years, the market capitalisation of the K-10 stocks rose sharply. Many of these stocks metamorphosed into being the most actively traded stocks in the country, with a widely dispersed shareholding including retail and institutional shareholders. SEOs by the firms helped improve dispersion of share ownership and improve liquidity. By 2000, the K-10 stocks no longer shared the characteristics of stocks which were attacked by manipulative cartels: they were not illiquid stocks which were held by a closely knit community which could coordinate orders and traders.

When stock prices of IT firms worldwide fell sharply in 2000, many speculators in India believed that stock prices of IT firms in India should also be much lower. These price declines had a magnified impact on Ketan Parekh's positions owing to leverage.

Every leveraged position which faces losses needs liquid funds in order to cope with mark-to-market payments. It is difficult to raise funds by selling shares, since this would generate further reductions in the price. It is believed that by late February 2001, Ketan Parekh had defaulted on payments on the illegal *badla* market on the Calcutta Stock Exchange. It is likely that at this stage, there would be extreme efforts in obtaining liquidity to cope with losses. It appears that at this stage, banking fraud surfaced in the form of fake pay orders from Madhavpura Bank.

[11] Among these are DSQ software, HFCL, Silverline, Pentamedia, Satyam, Zee Telefilms and Global Telesystems.
[12] These are HFCL and Zee Telefilms.

On 28 February 2001, the finance minister unveiled a widely acclaimed budget, and stock prices rose sharply. It is believed that Ketan Parekh and associates sharply increased the size of their leveraged positions. This information seems to have become available to the market at large, possibly through information leakage from the top management of the Bombay Stock Exchange. This inspired some short selling by speculators who predicted that these leveraged positions would break. On 2 March, the defence corruption scandal erupted, and the market index fell by 15% in a week.

It is possible to interpret the events that followed as a rational speculative attack. When a manipulative cartel has free capital and access to leverage, it is rational for an external speculator to not short sell a stock even if it is perceived to be over-valued. Once it appears that the manipulative cartel will be unable to "defend the price", the conditions are ripe for a speculative attack, where a large number of rational sepeculators independently choose to sell or short--sell the stock. This is similar to the well-understood currency crises where a large number of rational speculators sell a currency when it appears that the central bank will no longer be able to preserve a non-market-clearing price. By March 2001, there were thousands of speculators around the country who were focused on the K-10 stocks and had the capacity to sell them.

When the K-10 stock prices fell by roughly 10%, Ketan Parekh was bankrupt. This led to a payments crisis on the Calcutta Stock Exchange, which was partly a spillover of the default on the illegal *badla* market which had flourished in Calcutta. The largest defaulter on the CSE proved to be the stockbroker who was President of the CSE in 1996--98.

It is hard to decipher the relationship between Ketan Parekh and mutual funds. Based on publicly accessible information, we know that many mutual funds invested heavily in the same "K-10 stocks". These funds obtained extremely good returns from 1997 to 2000. It is hard to establish whether these coincidences in positions reflected speculative views which were independently arrived at, positive feedback portfolio strategies on the part of fund managers endowed with limited knowledge of modern finance, or collusive manipulation.

However, some disturbing fragments of information are available. For example, that HSBC Investment Bank was reported,[13] to have a portfolio of Rs.2.65 billion, of which 95% was made up of shares of one stock (Zee Telefilms) purchased in the second half of February. Such a lack of diversification is highly unusual for any fund manager, and the timing of the purchase does coincide with the precise period where Ketan Parekh was facing a speculative attack.

A. Regulatory reactions

The actions of government agencies (SEBI, UTI, RBI, the Income Tax department, and the CBI) in March 2001 may be summarised as follows:

[13] *The Hindu Business Line,* 10 March 2001.

- 3 March: SEBI decided to probe recent deals of Morgan Stanley, Credit Suisse First Boston, First Global, RS Damani, Nirmal Bang, C. Makertich and Calcutta-based broker, Ajay Kayan. A 40-man investigative team, including staff of BSE,NSE,CSE started work.
- 5 March: SEBI raised margins "in order to curb volatility". The SEBI chairman promised the media there was no payments crisis.
- 7 March: The BSE president, Anand Rathi, resigned. SEBI banned short selling "in order to arrest a fall in stock prices".
- 9 March: The first newspaper stories about the CSE payments crisis appeared. Newspaper reports said that UTI came in as a ``saviour", buying positions off brokers at the verge of default.
- 12 March: SEBI sacked all elected board members of BSE.
- 13 March: The run on Madhavpura Bank began.
- 15 March: CSE payout failed. RBI filed a criminal suit against Madhavpura Bank.
- 22 March: SEBI superceded CSE board.
- 23 March: Income tax department raided many brokers.
- 30 March: BOI links Madhavpura pay order to Ketan Parekh. CSE board resigns. Ketan Parekh arrested by CBI.

Based on publicly available information, it is hard to comprehend many of these actions:

- It is hard to see how SEBI's announcement of 3 March included names of specific entities, before an investigation had commenced.
- In times of market stress, it is important to ensure reliable access to liquid markets. SEBI's announcements of 5 March (raising margins) and 7 March (banning short selling) instead served to raise transactions costs.
- The SEBI chairman and the finance minister repeatedly said that there would be no payments crisis, but CSE did experience payments failures. This reflects poor information systems on the part of SEBI.
- UTI's role in helping entities on the verge of failure at CSE could be motivated by legitimate principles of sound portfolio management. On the other hand, this might have been motivated by a government effort to utilise assets of UTI's investors for avoiding a failure at CSE.
- It is hard to see why the Income Tax department would choose 23 March as a date to raid many brokers.

The crisis management by government agencies in March 2001 leaves a lot to be desired. Ideally, the actions of the state should display measured responses and confidence building measures. Instead, for the month of March, "regulatory risk", or uncertainties about government actions, was an important factor affecting the level and volatility of stock prices. Decisions such as banning short sales or raising margins served to reduce liquidity at a time when it was needed most. By the end of March, economic agents connected with the equity market were being investigated by numerous independent investigation teams, including SEBI, RBI, CBI, ED, JPC, EOW, stock exchanges, etc. Actions taken against many economic agents in recent weeks have been challenged as being based upon insufficient evidence.

VIII. Lessons

The account of crises above throws up numerous issues for public policy.

A. Market design and the functioning of exchange infrastructure

The first class of questions is related to market design and the functioning of market infrastructure. Largely speaking, it appears that these questions are behind us today. We now have electronic trading nationwide, novation at the clearing corporation, almost all settlement takes place at NSDL without physical share certificates. Starting with 2 July, all equity trading moved into rolling settlement. While there are many technical questions about how this new world will shape up (Shah&Thomas2001), it is clear that many major difficulties have been addressed. In the area of the debt market and banking, RBI has made important improvements to bond settlement (SGL) and banking regulations.

We may engage in some thought experiments, where we try to conjecture how the modus operandi of the crises of the 1990s would have shaped up differently with the present state of market design:

- Crisis 1992 (Harshad Mehta): Improvements on SGL and banking regulation have eliminated important sources of funds. The elimination of *badla* and the introduction of rolling settlement has eliminated an important source of leverage. It is clear that the methods employed by Harshad Mehta and associates in 1992 would not be particularly effective today.
- Crisis 1995 (M. S. Shoes): Pawan Sachdeva would not have been able to build up leveraged positions on M. S. Shoes under rolling settlement.

Suppose we assume that a clearing corporation provided novation for trades on BSE. Novation at the clearing corporation gives strong incentives to the clearing corporation to engage in sound risk management practices. Hence, the generosity displayed by BSE towards R. S. Jhaveri in terms of tolerating delayed margins is less likely in an environment with novation at the clearing corporation.

If R. S. Jhaveri had defaulted, novation at the clearing corporation would have ensured smooth functioning of the exchange, and the exchange would not have closed down.

- Crisis 1997 (CRB): There is relatively little that improved market design does in terms of forestalling the CRB crisis.
- Crisis 1998 (BPL, Sterlite, Videocon): In an environment with rolling settlement, large leveraged positions on these stocks could not have been built up. The governance problems of BSE, which were revealed in the efforts undertaken in dealing with the payments crisis, have yet to be satisfactorily resolved.
- Crisis 2001 (Ketan Parekh): Ketan Parekh and associates would not have been able to build up large leveraged positions under rolling settlement.

B. Governance at SEBI and RBI

The dominant source of difficulties that is with us today is difficulties in governance. The scam of 2001 has exposed important failures in supervision of banks. It is reassuring to note that the magnitudes involved in 2001 *are* substantially smaller than those seen in 1992. Yet, fraud in the banking system is very much a concern today, and RBI's existing supervisory capacity is clearly limited.

In recent years, SEBI's decision making and independence have been questioned on many occasions. SEBI made important errors in policy making by favouring the conservative position of not moving to rolling settlement in 1997. It is conceivable that the crises of 1998 and 2001 might not have arisen if SEBI's decision making process in 1997 had not chosen to block derivatives trading and rolling settlement. The CRB episode and the illegal *badla* on the Calcutta Stock Exchange are highly disturbing insofar as it appears that SEBI had good information about these illegal activities and chose to not act upon this information.

In the decade of the 1990s, the frontiers of India's securities industry were in the building of exchange institutions and sound market mechanisms. Looking forward, the most important frontier in financial sector policy now seems to be to rethink the mission statement, organisation design and political economy of policy formulation at RBI and SEBI. Better functioning at RBI and SEBI will help in the development of market mechanisms. In addition, sound functioning at RBI and SEBI is essential for taking preventive action in situations like CRB and the Calcutta Stock Exchange.

Our experiences with the crises of the 1990s show governance at its worst once a crisis has erupted. Many quick actions in the immediate aftermath of a crisis are ill thought out; they serve to raise transactions costs and generate negative price shocks through liquidity premia. The processes of investigation and enforcement seem to function slowly, with many political pressures on where enforcement should be tough and where it should be lax.

As of yet, there are no effective mechanisms through which investors can sue firms involved in fraud. In the above case studies, SBI Capitals, BPL, Videocon, etc. would all be vulnerable to lawsuits, but in India the legal system does not seem to make this possible.

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Annex 2: Supervision and Regulation of the Indian Brokerage Industry

I. Background

The absolute number of brokers *appears* to be very large and dispersed across Indian exchanges as there are over 9,000 registered brokers and 4,500 registered sub-brokers. In the case of the latter no accurate registration process exists today and there may be as many as 100,000 such sub-brokers that include individuals or that are companies. Despite the appearance of such a large numbers of brokers and sub-brokers the reality is **very different** as illustrated in Table 1. This table suggests that when properly analyzed India has about 2,000 active brokers versus the 9,000 officially registered brokers. This very large adjustment reflects the fact that broker registration is often applied to each card a broker had even if it is the same entity holding multiple cards. There is also the impact of duplicate registrations when brokers have multiple branches and finally a large number of brokers (approximately 2,000) as shown in line 4 of Table—are inactive in that they are not really conducting brokerage business. Finally of the remaining 2,000 brokers about 500 account for a large proportion of the entire order flow as they handle R$1billion of turnover each (see Table 1 below).

Table 1: Brokers and Sub-Brokers

Type of Entity	*Brokers 1/*	*Sub-Brokers 2/*
1. Individuals	1,200	3,150
2. Partnerships	300	N/A
3. Incorporated	2,500	1350
4. Inactive Brokers 3/	2,000	N/A
5. Active Brokers (1+2+3-)	2,000	N/A
Turnover Handled		
1. >= R$ 1 billion	500	
2. >=R$ 10 million to R$ 1 billion	500	
3. <= R$ 10 million	1,000	

1/ About 5,000 brokers registrations are really duplicates once multiple branches and exchange registrations are excluded as well as the multiple cards on different exchanges.
2/ Information presented is only for the registered sub-brokers
3/ These are brokers that hold membership cards yet do not conduct any active business.

The brokerage industry in India like the listed companies and exchanges can be characterized as non-homogeneous and fragmented in a number of important dimensions. First, the brokerage community is very diverse ranging from very large local brokers and foreign owned broker dealers to the very small brokerage firms where the financial standing of such entities as well as the extent of dealings for own account and clients varies greatly. Second, despite the increased use of technology and related use of trading stations all over India by the two major exchanges there remain a huge number of unregistered sub-brokers and branch offices of brokers.

II. Findings

There is no real complete inventory of all market participants. This problem exists at the level of brokers, sub-brokers, final clients and more broadly for individuals involved in the brokerage and securities industry in India. This hampers the ability of the authorities and the exchanges (SROs) to implement any kind of systematic regulatory compliance program and hinders the ability of the authorities in investigations and in conducting enforcement actions or surveillance activities. It also hampers the investor confidence in the market place since creation of central registration process of all intermediaries would improve the industry standards and maintain professionalism for acceptance of the regulatory process.

Qualification requirements for those engaged in securities business although improving must be substantially improved to start to approach international standards. Brokers and sub brokers are the front line interface with retail investors. Therefore, the level of confidence that investors have in the securities markets depends largely on the quality of service they receive from brokers and sub brokers. To safeguard investors interest, both brokers and sub-brokers must be fully qualified via effective testing and certification program in securities market beyond current minimum academic requirement. Qualification standard will further allow the credibility of market with investors

The membership application process for brokers and sub-brokers is not based on a sufficiently rich information base that can allow the authorities to undertake adequate fit and proper tests due to limitations on data availability and sharing among different regulatory bodies or law agencies. Existing qualification criteria are also imprecisely defined and this leads to undue discretion being provided to the exchanges and authorities which in turn can actually harm the credibility of the membership process. Individuals having past disciplinary histories or criminal background would be able to become a member.

No real supervisory structure exists for sub-brokers. Currently there are no compliance requirements for brokers to have written supervisory procedures in place.

Use of nominee accounts and lack of a well formulated program for introducing unique client numbers both contribute to the ability of broker dealers to conduct what authorities refer to as "circular trades" or what sometimes are referred to as "wash sales". In addition use of such accounts and the related inability to often be able to detect the beneficial owner of securities can make investigations into manipulative practices much more complex.[14]

The process whereby brokers co-mingle proprietary and client monies is quite common as well as the practice of using client margin to fund proprietary positions. This practice even if illegal is very difficult to monitor given accounting processes at brokerage firms where client monies are kept in pooled accounts. The lack of explicit sub-accounts for each client and the need to employ compliance of the separation of each of these accounts and the own account for the broker proprietary operations is deficient.

[14] This kind of problem is present in many countries and is difficult to address all over the world.

In some cases brokers are providing what amount to de-facto investment advisory or investment management services to clients. This practice is done via pooled accounts and have not formally registered as portfolio managers or alternatively registered and established a formal collective investment vehicle (e.g. a mutual fund).

The compliance function within brokerage firms in India is not well developed and is not vigilantly enforced for the vast majority of registered broker dealer firms. This is a problem in that this function is the first line of defense against many forms of abuse and if well implemented it can greatly reduce the resources needed in inspection and even in off-site surveillance efforts.

Inspection and Investigation Processes for brokers are not adequate. The use of auditing firms in the inspection process has not created adequate incentives to institutionalize capacity in this critical area at the level of either SEBI or the exchanges. Accounting practices that may be adequate for tracking personal business progress are inadequate for investor protection and the process of strengthening in the areas of sales practice abuses needs to be revamped. Improvements in the areas of record keeping, capital maintenance, reporting and more frequent process of inspection as a means of education and enforcement is required.

There appears to be inadequate coordination in the inspection process between SEBI and each exchange and the process of timely information sharing and related investigations is not yet in place or well structured. MOU - Memorandum Of Understanding needs to be jointly signed between exchanges and SEBI with regard to sharing of relevant regulatory information. To develop a good working relationships between the MOU parties, joint initiatives or sweeps needs to carried out so that indirect message is sent out to the market participants that regulators are teaming up and will not tolerate any market abuses.

III. Recommendations

To address the many deficiencies noted above will involve adoption of a package of measures in eight inter-related areas. In each area and across each there will be the need to set realistic priorities. The recommendations form a consistent package in that efforts to improve regulation and compliance at the broker dealer/client level in India must start with improvements in very basic and important forms of information infrastructure such as defining and inventory of what entities or individuals are in the securities or more narrowly the brokerage industry.

A. Develop a proper inventory of market participants

- **A better method of inventory requirements of all sub-brokers is needed.** There are over 100,000 sub-brokers engaged in the securities market and there is a need to develop a mechanism of registration of all sub-brokers via unique identifiers and monitoring those requirements through brokers. Create a database of all authorised persons profile engaged in the securities business with their location, qualification and business activity, employment history and records of any disciplinary actions taken against those individuals. With improved control of sub-brokers and client identifications, the relationships of broker/client is also recognised and interactions between them

- **Branch Office registration requirements for brokers and sub-brokers need to be implemented.** - currently there no requirements to report to the exchanges or SEBI with regard to opening of branch offices and type of business activities at those branch offices. Supervision issue at the branch office level is non existent. Currently there are approximately 4,000 registered entities with over 9,000 exchange membership. There are no known number of branch offices of these registered entities. Opening and closing of branch offices is known to NSE only for the purpose of using the terminal. If introducing business is carried out at a branch office without the need of a terminal, there would be any record of that branch office.

- **Develop categories of brokers and sub-brokers** - Categorising brokers and sub brokers with regard to specialisation of products and services would allow for different level of capital requirements for those brokers and better control for risk management. The current "net worth" requirements be redesigned as "net capital" requirements, establish a singular method of computing net capital and incorporate the requirements into the regulations via development of a new rule. Sub- broker categorisation by job function would allow for better compliance requirements by brokers. (Additional information to be provided + see Inspection area)

B. Improve the quality of Market Participants (Brokers and Sub-Brokers)

- **There need to be qualification requirements for all persons- Employees of members, especially authorized persons actively engaged in the securities business**. All members should be required to take a qualification examination testing their knowledge of the capital, debt markets, specialized products, the laws and regulations applicable before they are permitted to engage in such activities. All persons dealing with the public be required to take such a qualification examination.- Qualification examinations would test personnel on their knowledge of all market products, and their knowledge of the applicable laws and regulations This requirement would add to the credibility of well regulated marketplace. Also personnel by 'job function and requiring the passage of pertinent qualification examinations (FINOP, CROP, SROP), Compliance officer, General Securities Principal, etc. -

- **Supervision requirements of sub-brokers** - Currently there are no written supervisory structure or procedure requirements of sub-brokers at the "home" or branch offices. This process allows them to engage into various sales practice abuses and manipulative practices.

- **Membership** - Administer stringent membership requirement with consistency and uniformity across exchanges - capital requirements, qualifications and credit worthiness of applicants as well as known sub-brokers to be associated with that broker. The membership requirements in addition to those required by current regulations would allow greater public awareness and improve the quality of brokerage services. Membership exit processes need to be improved and enforced. Currently there are brokers who remain active without conducting any transactions. Reasons for maintaining this membership is unknown but may be due to unfavorable market conditions or some type of issues with clients/sub-brokers. Rules need to be developed whereby the exit process would apply if a member has not conducted any business for a period of one year.

C. Improve the quality of Inspections and Investigations

- **Number and Quality of Inspections** of members operations be materially increased with risk based approach for identification of members and areas of focus of inspection. Current requirements by MOF is 10% of membership. Goal and a plan of action to accomplish annual inspection cycles of members of regulatory concern. Consider conducting joint (SEBI + Exchanges) through inspection with different areas of focus including examining branch office operations. Frequency of inspections need to be increased to provide adequate surveillance effort for a self-regulatory organization. An annual inspection cycle will necessitate a increase in staff dedicated to this task and an in depth focus on their training. It is recommended that goals and a plan of action need to be prepared over period of two years for this accomplishment. (Additional information to be provided) Frequent regulatory examinations protects the system and build investor confidence in market place. Requirements for books and record, capital and reporting adds substance to the current system and will add stability as well as visibility.

- **Gradually phase out use of outside professions (Chartered Accountants) for member inspection or implement measures to introduce greater accountability via use of performance bonds for auditors as in Argentina.** Current regulation should be amended to provide that when outside professionals are to be used in an inspection care be taken to insure that none of them or their employers have a conflict of interest or that their employer is not a competitor of any of the members to be examined. This will -give greater and closer control over the inspection process and will eliminate the possibility of conflicts of interest existing between the outside auditors and the member being inspected. During the phase when outside personnel are being used, process must assure that no such conflicts exist, not only as to the individuals involved but as to the firm with which they are employed as well. This is fundamental and if not adhered to could seriously undermine- not only the inspection process but also the perception of fairness and objectivity. Over the period of next two years consider phasing out the use of outside auditors professions so that local knowledge is maintained within the regulatory bodies and consistent standard are employed. Confidentiality agreement need to be signed and various areas of current inspection process improvement is required. CA does not fully understand the securities market and compliance standard requirements. Being in house inspections allows better communications and guidance to members and allows better informed measures of preventive compliance mechanism.

D. Develop new rules for broker dealers vis a vis their clients as well as modify and strengthen existing regulations.

A package of measures needs to be implemented going forward that can act to create natural incentives for further broker consolidation.

- **Net Capital Rule** – The current "net worth" rule should be designated as the "net capital rule" and should be gradually phased in over the next three years. This must be implemented gradually as much better information is developed about the balance sheets of the broker dealer firms permitting better off-site and onsite monitoring of net capital. There will need to be provisions for requiring the filing of monthly/quarterly summary financial statements similar to FOCUS filings; require that the member notify the Exchange if its capital falls below requirements, and that if such occurs the member be immediately suspended until he again brings himself into capital compliance. One set of capital rules with consolidated accounts will expose system risk before an event destabilises the system. Capital requirements protects investors and the system. Requiring net capital and reporting will add stability to the distribution channels as well as visibility. See risk management area -

- **Commissions Charges for Services Performed** This rule would require that all charges made by brokers and dealers be reasonable and not unfairly discriminatory between customers. Current guidelines under SEBI is very broad.

- **Termination of Personnel**-This rule would require a member to notify the Exchange of the suspension or dismissal of any employee or officer for cause. It would complement the Exchange's inspection program and would trigger an inquiry of the member to ascertain the specifics of the cause for the termination and perhaps further investigation. It is recommended that a form be developed for this purpose which would require among other things disclosure of the reason for the termination. This information would then be updated into the central database discussed earlier. **Sending of Customer Account Statements** Current requirements are issuance of contract notes with 48 hours of transactions. This rule modifications would require the mailing quarterly of account statements to customers whose accounts have a security position or money balance or in which there has been activity during the quarter.

- **Rule Requiring Compliance Departments/Officers-/Supervisory Procedures-** In most cases securities firms in India do not normally have compliance departments or compliance officers. Rule needs to be developed requiring that all firms have an organised compliance function whether in a separate department. Written supervisory procedures should also be required for monitoring the activities of personnel engaged on behalf of the member in securities activities, especially those who are dealing with the public. The supervisory procedures would be administered by a compliance officer who would be responsible for administering the compliance function. This requirement for all members irrespective of the size of the firms. Each firm must develop their own set of written supervisory procedures applicable for their operation.

E. Expand Preventative Compliance Program

Prepare publications with simplified rule interpretations. Conduct various membership seminars and address common market related issues/trends. Through inspections/investigations and risk management, advise the types of preventive measures that a member can proactive measures of compliance.

F. Improve Co-ordination and Communication between Exchanges and SEBI and other Regulatory Agencies (RBI, DCA)

Including better mechanisms of data sharing between Exchanges, SEBI and other Regulatory bodies

G. Improve the quality and number of Exchange and SEBI Inspection staff over the next two years

- **Increase inspections and investigations staff at home and regional offices of Exchanges over two years** - 25% during 1st year and another 25% 2nd year. Complement this with actions to restructure the (Additional information to be provided)

- **Comprehensive Practical Training** - The average inspection staff in either the exchanges or SEBI has post-graduate education, but little practical experience Qualified staff need to be developed with on the field training programs through in-house seasoned inspectors.-

- **Staff Retention Incentives/ Change Salary Structure.** Although policies in this area appear to be sufficient on the exchanges they are not so in the case of SEBI where this issue must be addressed urgently. - Encourage staff to transfer within so that local knowledge and experience is retained "inhouse".

- **Establish better working relationship between Exchanges, SEBI and other Regulatory Agencies** - MOU - Memorandum Of Understanding needs to be jointly signed between Exchanges, SEBI and other regulatory bodies with regard to sharing of relevant regulatory information. To develop a good working relationships between the MOU parties, joint initiatives or sweeps needs to carried out so that indirect message is sent out to the market participants that regulators are teaming up and will not tolerate any market abuses

H. Improve the process of Investor Education

- Public awareness, confidence in public, investor seminars, market participants, change investor culture by education, Internet media, newspaper, television
- The first step in investor education program is via educated intermediaries. All registered sub-brokers can educate the investors. This is another good reason to develop good inventory of all sub-brokers and establish high qualification standards so that investors can be educated.

Annex 3: Regulation of Issuers and Exchange Listings in the Indian Capital Markets

I. Overview

India's capital markets have experienced massive change and growth in the past 10 years or so. Many regulations, standards, institutions and market practices have been introduced or developed only recently. It is imperative to recognize the significant progress that has been made on many fronts. The brisk pace of reform and raising of standards is continuing, if not accelerating, making it challenging for all market participants, including public companies, to keep abreast of and adapt to the changes and stricter standards. However, the considerable progress made to date encourages the view that additional improvements can be achieved in the next few years.

With respect to issuers, or the listed companies, several important concerns exist that negatively impact market integrity and investor confidence. Foremost among these are lack of centralized regulatory oversight over public companies from a securities regulation standpoint, multiple listing of stocks across a fragmented exchange system, and a general failure to establish and enforce reasonable minimum standards for public listing and trading of corporate equities. These structural problems have in turn given rise to concerns over the quality of disclosure and corporate governance, general compliance with securities regulations, and the role of promoters of companies in the securities markets. The primary problems are structural in nature, not process-oriented.

II. Background Information

The stock markets are fragmented in several dimensions, with extensive cross-listing of securities over 23 stock exchanges, and the markets lack consolidating mechanisms that would aid market efficiency and regulatory effectiveness. On the other hand, only 2 exchanges are of significant national importance, and regional exchanges are of rapidly declining significance. Only 2 regional boards have material trading activity, Delhi and Calcutta. NSE and BSE dominate trading, and the bottom 17 exchanges accounted for only 1% of trading in March 2000.[15] Many regional exchanges have actually or virtually ceased trading activities.

Almost all stocks traded on the NSE are also listed on BSE, and there is extensive cross-listing of stocks with regional exchanges. Over 9000 companies' securities are publicly-traded (9,871 as of March 2000)[16], but a significant percentage are not meeting even basic standards that would normally be required to qualify a company for exchange listing in other jurisdictions.

[15] NSE, Indian Securities Market – A Review
[16] Ibid.

With almost 6000 listed companies (LCs) on BSE and over 1000 on NSE, the exchanges face a monumental task in regulating issuers, particularly given their limited powers and range of sanctions for non-compliance. The consensus is that there are about 100 "quality LCs" that are the focus of foreign institutional investment. About 200 companies comprise the overwhelming majority of market cap and trading.[17] Standards of disclosure and compliance are generally good amongst this group, especially the top 100. Below this, the consensus among both regulators and market participansts is that quality and compliance fall off rapidly.

The "vanishing companies" initiative is also illustrative of the problem, generally referring to the program undertaken from 1996 to identify companies that have stopped communicating with the shareholders and exchanges, and which have no trading in their stock.[18]

Overall, SEBI plays a fairly small role in regulating listed companies with securities trading in the secondary market. Even for primary market issues, SEBI does not actively vet prospectuses for compliance with its DIP (Disclosure and Investor Protection) guidelines, but relies mainly on the sponsoring merchant banker to ensure compliance. Furthermore, SEBI lacks the effective powers necessary to investigate and pursue non-compliance with most requirements applicable to listed companies. Even where powers exist, there is a lack of clarity in the law about their nature, as well as which authority is primarily responsible for a particular area.

The concept of listing is primarily a regulatory concept in India. NSE in particular views listing as a regulatory, not a business, concept in spite of its status as a for-profit exchange. BSE appears to view listing as both a regulatory and a business concept, in spite of its non-profit status. In both cases, listing fees account for only a minor portion of revenues. This view may well change with the demutualization of all Indian exchanges.

Internationally, listing on exchanges is generally viewed as a central element of an exchange's "brand", and the quality of its stock list represents reflects both the attractiveness of its product and the integrity of its market. For these reasons, while the approval for listing, and ongoing regulation or supervision of listed companies is a regulatory function performed by exchanges, it is generally viewed as tied directly to their business. It is also not, strictly speaking, a self-regulatory function akin to exchanges' roles as SROs responsible for regulating their member firms in the traditional mutual model.

III. Key Findings

1. It is widely perceived that promoters and insiders of LCs are involved in manipulative activities and insider trading that have periodically been the source of scandals in the markets.

[17] 95% of BSE trading is in the "A group" of 176 issues; considered the "blue chip" list.
[18] 4146 companies that went public from 1992 to 1998 were reviewed; 318 were in violation of the Listings Agreement. Of these, only 80 could not be traced.

1.1 But there is a lack of firm evidence to support the strength of this finding. It is based on reports on past scandals, anecdotal information, press reports and so on. The manipulative actions allegedly include both trading activity designed to influence the prices of securities, and misrepresentations in corporate disclosure.

2. SEBI's authority over public companies is limited and does not conform to the prevailing model for securities regulators. The division of authority over issuers amongst the regulators is not clear, which reduces the efficacy of issuer regulation, and gives rise to confusion among investors, issuers and the regulators themselves.

2.1 SEBI lacks both comprehensive jurisdiction and enforcement powers over issuers' securities market activities and interaction with investors, including the critical area of disclosure. SEBI has limited and somewhat unclear or shared powers in this field, and does not have the power to fine issuers or require disclosure (outside of the primary market). SEBI does have general authority under s. 11B which it has occasionally used against companies.[19]

2.2 There is no single securities law that establishes the concept of a registered issuer or security, and that sets out the disclosure obligations for public companies, and other requirements for the protection of shareholders and investors. The laws relating to public companies' securities issues is variously set out in the Companies Act, 1956, the SEBI Act and the Securities Contracts (Regulation) Act. These laws have been amended on a piecemeal basis over the years, and have not been consolidated into a comprehensive legal code. It appears that the fact SEBI was only created relatively recently is one of the main reasons its powers are limited and lacking in clarity.

2.3 Furthermore, the law is not clear on which regulator has primary authority for many areas, as a number of powers are shared by SEBI and Department of Company Affairs (DCA), and in some cases the stock exchanges and the Central Government as well. The lack of clarity has given rise to conflicts and lack of communication among the authorities, and to some degree confusion about the role and responsibility of the institutions involved. Although the DCA Secretary is on the SEBI Board, and SEBI is represented on the boards of the exchanges, this has not resulted in the necessary cooperation or provided the necessary clarity on their respective roles.

2.4 The SEBI Act does give SEBI the power to make regulations on the issuance of securities and related disclosure[20], referring to primary issues, which have led to the Disclosure and Investor Protection Guidelines applicable to IPOs and other new issues of securities.

2.5 As a practical matter, the primary source of regulation of issuers is the Listings Agreement, the contents of which are mainly established (and must be approved by) SEBI, but which is in fact a contract between the issuer and the relevant

[19] S. 11B of Securities and Exchange Board of India Act; for instance to issue show cause notices to directors of "vanishing companies".

[20] S. 11A of Securities and Exchange Board of India Act.

exchange, which is administered and enforced by the exchanges. Each listed company is required to have a compliance officer for this purpose.

2.6 The division of responsibilities between SEBI and the Exchanges lacks definition because SEBI determines the content of the Listing Agreement but the Exchanges administer and try to ensure compliance with it. To further complicate matters, Exchanges are empowered by law to make rules on the listing of securities[21], and SEBI is empowered to directly make rules for the Exchanges[22], meaning it has authority to pass rules regarding listing, although this is clearly designed to be used in extraordinary circumstances.

2.7 The Exchanges have the primary responsibility to monitor compliance with, and enforce, the Listings Agreement. See 3. below concerning the implications of this fact. The primary purpose of a Listing Agreement in other jurisdictions is to set out the terms and conditions of listing on the relevant exchange, not to establish a comprehensive code of regulations for public companies. These two objectives are mixed in the current regulatory regime in India. SEBI is using the Agreement to establish regulatory requirements for public companies, and has oversight responsibilities for the Exchanges' activities in this area, but SEBI lacks clear authority to enforce the Agreement, even on referral from the Exchanges. Further, SEBI has not established a program or provided resources for the monitoring and enforcement of these requirements.

2.8 The Securities Contracts (Regulation) Act does give legal backing to the Listing Agreement, in requiring compliance with the terms of the Agreement.[23] SEBI has some general authority to enforce this provision, although it is rarely used, since compliance is viewed as a function of the Exchanges.

2.9 SEBI's oversight inspections of the exchanges address Listings functions. SEBI also receives certain reports from the exchanges on non-compliance with Listing Agreements, including all trading suspensions[24]. However, the reporting arrangements are not uniform across the Exchanges, and SEBI does not appear to have been proactive in this area.

2.10 Examples of the requirements set out in the Listing Agreement include:

- The Corporate Governance Code, which sets out comprehensive governance standards and requirements for public companies, parts of which SEBI has mandated via the Agreement[25];
- Contents of quarterly and annual financial statements;
- Contents of annual reports;
- Disclosure of price-sensitive information[26];
- Filing of major shareholders (5% + stake);
- Take-over bid rules;

[21] S. 9(2) of the Securities Contracts (Regulation) Act

[22] S. 10

[23] S. 21

[24] BSE has identified about 10 clauses they believe SEBI is concerned with, mainly relating to disclosure. We were advised that SEBI has not established parameters for reporting non-compliance.

[25] Implementation is being staged by size of company – by March 31, 2001 all BSE A group and S&P Nifty index companies must be in compliance.

[26] The Listings Agreements were recently amended to require companies to provide notice of a number of decisions within 15 minutes of the end of a Board meeting. See BSE Notice dated March 12, 2001.

- Disclosure in offering documents;
- Compliance with corporate laws.

2.11 In addition to the standard requirements of the Listings Agreement, each exchange maintains its own minimum listing requirements, covering matters such as minimum issued capital, public float, etc. Requirements are set out for new public offerings, and for listing of companies listed on other exchanges.

2.12 The BSE has initiated a program of vetting the disclosure document required by the DIP guidelines for IPO listings, in an attempt to plug the regulatory gap. This includes a merit-based review[27], but the Exchange is not sure that this activity is within their jurisdiction or properly their role. SEBI views primary issuances as its domain, and is attempting to limit the BSE program, but without proposing any substitute, notwithstanding that BSE's initiative is clearly aimed at improving market integrity. This situation illustrates the kinds of problems that are arising with the current regulatory system.

3. The Exchanges lack adequate authority and remedies to fully monitor compliance with and enforce the Listings Agreement. They also lack the resources to do so with the necessary efficacy. Stronger measures and remedies are required to improve compliance with regulations.

3.1 The Exchanges' only effective remedy is suspension of trading, which is a limited form of sanction[28]. Suspension of trading harms the investor as much as the company, and is not effective against companies that are in material violation of the Listing Agreement and do not intend to comply. The exchanges do not have the power to fine listed companies, or to employ other disciplinary remedies. This regime is consistent with the primary international model for listings arrangements on exchanges, and with the principle that listing is a contract setting out the terms and conditions of posting a security for trading, not a self-regulatory function. However, in other jurisdictions the exchanges are not cast as the primary regulators of listed companies.

3.2 Moreover, SEBI has effectively removed delisting as a tool for the exchanges by their directive to exchanges not to delist stocks pending a decision on a SEBI committee's review of the delisting issues.[29] The Exchanges would like to resume the use of delisting as a tool, in order to deal with companies that are in ongoing violation of material clauses of the Listing Agreement.

3.3 The Exchanges, especially BSE with its huge stock list, attempt to fill the regulatory gap with programs for monitoring compliance with the Listing Agreement, but lack the authority, remedies and resources required to effectively enforce the comprehensive regulations included in the Agreement.

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[27] BSE has rejected 24 of 110 issues for listing since April 2000.

[28] The exchanges can charge a reinstatement fee before lifting a trading suspension.

[29] A joint committee of SEBI, DCA and the exchanges (the Chandratre Committee) on delisting vanishing companies made recommendations some time ago but no policy decision has been taken. The recommendations focus on the rights of shareholders to notice and a hearing prior to delisting, as well as the need for a market to trade the shares in following delisting.

3.4 For example, the BSE's Corporate Relations Dept. is responsible for the Listing Agreement. BSE has established 5 key criteria in the Listing Agreement that will trigger a trading suspension immediately[30]. LCs in violation of any 3 of these are transferred to the "Z group" tier of the stock list.

3.5 Although the BSE and NSE, in particular, have monitoring programs in place, neither investigates nor inspects corporates in the same manner as they do in regulating their member brokers; ie. carry out on-site inspections, or formal investigations for the purpose of taking enforcement action. Matters requiring formal investigation are referred to SEBI.

3.6 Both exchanges have investor complaint cells that follow up on investors' complaints about LCs.[31] These usually pertain to shareholder issues such as dividends, share transfers, etc. Significant complaints can lead to suspension of trading, but the exchanges' limited powers make it difficult to remedy major problems. For example, many complaints to BSE are against "Z group" companies that are already suspended for violations of the Listing Agreement.

4. Multiple listing of stocks complicates and compromises the effective enforcement of the Listings Agreement, and leads to unnecessary duplication of activities across the exchanges.

4.1 Each exchange is responsible for ensuring compliance by all of its LCs with the Listings Agreement. The exchanges do not coordinate their compliance efforts in cross-listed stocks, beyond circulating a list of stocks they have suspended. This situation enables a stock to continue trading on one exchange even if it is suspended on another, reducing the effectiveness of compliance efforts.[32] It also creates a disincentive to taking action on non-compliance on multiply-listed stocks since an exchange may not want to be the first to suspend trading for competitive reasons. These types of commercial pressures will increase with demutualization.

4.2 The large number of exchanges also enables a company to "shop around" when first applying for listing, and to seek listing elsewhere if turned down at one exchange. This creates an incentive to list companies that may not be suitable for public markets.[33]

4.3 The system also means that exchanges are duplicating the activities involved in monitoring compliance and following up, for any company listed on more than one exchange. This not only increases regulatory costs, it increases the regulatory burden on companies (which must deal with multiple exchanges on the same issue) and results in inconsistent policies and processes being applied to the same

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[30] BSE notice 13 Dec. 1999 specifies notice of record dates, payment of listing fees, publication of financials, filing annual reports and resolving investor complaints.

[31] BSE has 35 staff in Investor Services, about 40% dedicated to complaints. As of April 2001, BSE had almost 15,000 unresolved complaints, half of them against "Z group" companies. Over half of the complaints against regular companies had been open for over 90 days.

[32] The exception is suspension for suspected price manipulation, which occurs at all exchanges for a maximum of 3 days, and is automatically referred to SEBI.

[33] "The lure of listings fee at times induces some exchanges to dilute their listing standards and grant listing to a security, which was rejected, by other exchanges.": NSE, Indian Securities Market - A Review, p. 108

issue at different exchanges. This approach is especially illogical given the fact that most of the provisions of the Listing Agreement are uniform rules of corporate conduct imposed by SEBI across all of the exchanges.

4.4 We were advised that regional exchanges' resources and efforts to monitor and follow-up on compliance with the Listing Agreement is minimal.[34] In practice, there is heavy reliance on NSE and BSE. This exacerbates the problems created by multiple listing of securities.

5. BSE and NSE Listing Department processes for vetting new listing applications and monitoring compliance with continued listing requirements are similar to North American processes.

5.1 Standards and procedures are difficult to assess given the scope and timeframe of our review, but staff at the two major exchanges appear to be well qualified and professional. Policy and processes are well thought through, and largely consistent with those in place at North American exchanges. Process improvement programs are in place, particularly at BSE.

5.2 BSE is implementing a Centralized Compliance Monitoring System (CCMS) to record and track LCs' compliance with Listing Agreement requirements. It includes automated exception reports to flag failures to file and other potential problems. The System will integrate 4 existing databases containing data on LCs, and will encompass all clauses of the Agreement. It will also serve as an "extranet" to facilitate electronic filing of information with BSE, and communications with LCs. This type of system represents a move to international best practices, and should be employed by all exchanges. It should also be integrated with SEBI's initiative to create an electronic filing system, to eliminate duplicative investment in systems and the need for LC users to deal with multiple platforms.

5.3 The exchanges have due process procedures for trading suspensions and delistings, including notice, hearings and rights of appeal. The BSE and NSE each have a panel to approve delisting. The securities continue to trade for a period of one year after delisting is approved, on the theory shareholders should have an exit opportunity (if there are any buyers). These processes appear to be satisfactory, although the one-year notice period is excessive.

6. SEBI lacks the number and quality of staff necessary to carry out even its current role relating to public companies.

6.1 SEBI's primary role is to establish the policies and standards for accessing the public markets (through the DIP guidelines) and the ongoing requirements of public companies (through the Listing Agreements). Most staff involved in work related to corporates work in primary markets. Less than 10 staff members work on secondary markets, or issues relating to listings. Currently it is a policy-making role, which requires limited staffing. SEBI is not equipped to carry out active

[34] "Many exchanges are too weak organizationally to monitor compliances of obligations." Ibid.

review of offering documents, monitoring of corporate compliance with standards, or to thoroughly oversee the exchanges' efforts in this area.

7. The quality of continuous, periodic and financial disclosure varies. Disclosure requirements and standards have improved greatly in recent years. The practices of tier 1 LCs are fairly good, but further improvements need to be made in this area, particularly in enforcing requirements for small and micro-cap LCs.

7.1 Accounting standards and disclosure requirements are stated to be fairly good relative to Asian practices, with significant improvements noted by market participants in recent years. For tier 1 companies, market discipline and peer pressure to conform to best practices has had a major impact. This is particularly true for companies attracting FII investment. However a widespread consensus exists that non-compliance remains significant outside tier 1, and that much better monitoring and enforcement is required in order to change corporate culture and attitudes in this area. This consensus ran across SEBI, the exchanges, market participants and professional advisors.

7.2 Even for tier 1 companies, the breath and depth of public disclosure should be enhanced. For purposes of research analysts, discussions with management, suppliers, industry experts etc. are necessary to develop a complete and accurate picture of the company's business and prospects. Accounting standards could also be expanded in certain areas. The number of qualifications to auditors' reports on financial statements, especially companies in the public sector with government ownership, is viewed to be a problem.

7.3 There is also a consensus in favour of further extending requirements along the lines of best practices in developed markets. For example:

- Auditing of quarterly or semi-annual financials
- Segmented reporting in annual reports
- Meaningful management discussion and analysis (MD&A) disclosure, including forecasts
- Disclosure of major shareholders
- Consistent application of accounting standards and explanation of any changes.

7.4 BSE and NSE have made substantial efforts to ensure companies issue price-sensitive announcements in a timely manner. Both exchanges disseminate corporate news on their websites, and have rumour verification programs. However, it is generally conceded that compliance needs improvement, and that companies do not release the breadth and depth of information being disseminated in developed markets. Process improvements are also required, including a requirement to file electronically. Currently reports are received by e-mail, fax and even the post.

7.5 SEBI has an electronic filing project underway designed to create a system like the SEC's EDGAR. However, it is not clear that a stand-alone system is required given the availability of Internet-based solutions. As noted elsewhere, this initiative should be integrated with the exchanges' efforts to establish electronic filing systems and central databases on listed companies, such as BSE's Central Compliance Monitoring System.

IV. Major Recommendations

1. SEBI should assume primary responsibility for the regulation and oversight of publicly-traded companies in terms of requirements relating to clearing new issues, disclosure and investor protection.

1.1 The Listing Agreement should cease to be the primary source `of rules and regulations governing issuers' (corporates') obligations to investors and the securities markets. Securities legislation and SEBI regulations should set out the primary disclosure and investor protection requirements for issuers. The SEBI Act or a successor comprehensive securities act would be the logical place for such provisions.

1.2 The legislation should give SEBI the full range of powers and sanctions necessary to enforce compliance with requirements, including the power to cease trading in a security, issue cease and desist orders, and other provisions noted in the section of this Report on SEBI powers.

1.3 SEBI should have clear authority to bar a person from acting as a director of a public company, in order to reinforce its powers to ensure persons responsible for actions of corporations comply with the provisions of securities laws and regulations. Apparently SEBI has employed its general power under s. 11A to disqualify a person from raising capital or becoming a director of a company going public, but this is a general power, not a specific one, and is only used in limited circumstances.

1.4 The Listing Agreement should cease to be the primary source of rules for issuers. The Listing Agreement, and the exchanges' role in monitoring compliance of LCs, should be limited to the specific requirements of the relevant Exchange, and any functions delegated by SEBI (eg. monitoring of issuance of price-sensitive or material news announcements). The Exchanges should be permitted to establish any additional requirements (over and above those set by SEBI) they deem suitable to maintain and enhance the quality of their markets.

1.5 The Department of Company Affairs (DCA) should focus on general companies law matters, and not matters relating to the public issuance of securities, the trading of companies' securities in secondary markets, corporate disclosures or issues relating to investor protection. These matters should be exclusively within the purview of SEBI, and be moved to securities legislation from the Companies Act. The sharing of powers currently provided for in the legislation should be eliminated in order to clearly establish the authority and accountability of the different agencies.

1.6 SEBI should establish a Corporate Finance Department with resources sufficient to administer the laws and regulations promulgated in this field, including those regulations SEBI administers today, such as the DIP guidelines and the take-over bid rules. This Department should, at a minimum, be charged with the following responsibilities:

- establishing the requirements for a IPO or new issue
- vetting disclosure required for new issues (prospectuses)
- maintaining a register of public companies or securities
- establishing and monitoring continuous and periodic disclosure requirements
- enforcing compliance with applicable laws and regulations.

1.7 SEBI should be empowered to impose filing and registration fees on issuers as required to finance their regulatory activities relating to corporates. This revenue would replace the share of the listings fee currently received by SEBI.

2. The requirement for public companies to list on a regional exchange should be eliminated. Companies should choose which exchange(s) to list on based on their assessment of the needs of their investors and other market considerations.

2.1 The Ministry of Finance Circulars under the SCRA require listing on the regional stock exchange nearest to the company's registered office, generally interpreted as the exchange in the state where the company is located. The regional exchange is the "primary listing" and must approve the company before it can be listed on any other exchange. With the advent of NSE and BSE as national markets, this provision is obsolete, and should be repealed. (Also, companies with paid-up capital of Rs. 5 crores or more must list on at least one other exchange, and companies are also required to list where their principal business is located. These provisions should also be eliminated.

2.2 The Companies Act requires any company offering securities to the public to apply to one or more exchanges to list the securities. This provision continues to make sense if public policy is to require publicly-traded securities to trade on a recognized exchange. The alternative would be to allow an over-the-counter (unlisted) market to develop, but OTC trading is not recommended because it would likely create additional regulatory problems associated with monitoring of issuers and markets.

2.3 The regulatory regime should remove artificial subsidies of exchanges and encourage competition among exchanges for listings. This will encourage exchanges to focus on providing superior service to LCs and their investors, and would likely encourage consolidation amongst the exchanges.

2.4 Listing fees should be set by Exchanges based on commercial and competitive considerations, and should not be regulated.

2.5 Exchanges should cooperate in the administration of their Listing Agreements in order to minimize problems with regulatory arbitrage and duplication of functions. Under such an approach, monitoring compliance would be enhanced, and the compliance costs would be reduced for both LCs and the exchanges. (Note that if recommendation #1 is adopted, the role of the exchanges in this area would be significantly reduced.) The Exchanges may wish to designate a "primary exchange" for each company, which would be responsible for administering all common requirements of the Exchanges. This designation could be based on trading volume, and adjusted periodically. Under this system, each of the other exchanges would address only requirements particular to their rules.

2.6 Another option is to designate one "Listing Authority" along the lines of the UK regime, which would establish one national standard for listing across all exchanges, and administer those requirements. This approach is advocated by NSE in its India Securities Market Review.[35] It is based on the view that public policy should establish one national standard for accessing public markets. The counterview, and the view advocated in this Report, is that SEBI should establish basic minimum standards, but exchanges should be able to compete by establishing different listing criteria. In this way, exchanges may establish standards of quality for their stock lists, much as NSE has done in limiting the size of its stock list. However, companies that do not qualify under the standards of the most restrictive exchanges would not be prohibited from tapping public markets, provided they meet the minimum requirements established by the regulator, SEBI.

3. *The Exchanges should be permitted and encouraged by SEBI to delist* inactive LCs, as well as LCs in ongoing violation of requirements.

3.1 SEBI should lift its temporary prohibition on delisting and either require or encourage the exchanges to raise their listing requirements in order to deal with inactive and non-compliant LCs, for the purpose of improving the quality of the exchanges' stock lists, as well as compliance with regulatory requirements by issuers.

3.2 The BSE, in particular, should raise its requirements and reduce the size of its list in view of its role as a national exchange and its proposed demutualization.[36] The listing of a large number of companies that are not in compliance with the Listing Agreement and that attract minimal trading volumes is inconsistent with the role of both a national market and a for-profit exchange.

3.3 Furthermore, from a public policy standpoint, the existence of a vast number of publicly-traded companies that are not actively carrying on business, and/or are materially in violation of the Listings Agreement, negatively impact the integrity of India's capital markets and the ability of public markets to finance economic activity. The number of LCs that do not represent real investment opportunities for investors, and real economic activity, detract from investor confidence, and thereby compromise the market's ability to provide equity financing for economically active entities. Since inactive companies often serve as vehicles for promoters and can be subject to market manipulations, their continued existence negatively impacts market quality and integrity. These companies are also a significant drain on the regulatory resources of the Exchanges and SEBI, which would more usefully be focused on companies with substantive businesses.

3.4 A sizable percentage of India's 9000-odd public companies are not actively carrying on business and/or are in violation of their Listing Agreements. The BSE's "Z list" of companies in material violation contains 1,485 companies;

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[35] p. 108

[36] The NSE already has a program to gradually reduce the number of "permitted" but unlisted companies by targeting problems such as non-compliance with requirements with the Listing Agreement at other exchanges such as BSE. This is primarily for regulatory, as opposed to business, purposes.

trading is suspended in about 1,100 of them.[37] In fact, BSE is only receiving filings from about 3,500 companies, meaning about 2,500 companies are either not carrying on business or have effectively abandoned their listing. BSE staff estimate that about ¾ of these are no longer in business.

3.5 The efforts involved in monitoring and following up on LCs' failure to file reports, tracking down inactive companies, and other forms of non-compliance consumes significant resources, especially at BSE. However, the scrips involved account for very little trading activity (many are in fact suspended). It is not economically viable for a for-profit exchange to maintain the listing of such securities.

3.6 The exchanges currently have procedures for delisting of securities which appear to provide for due process, including notice to shareholders and the market. The company has the right to be heard and may appeal to SEBI. During the "notice period", the scrip continues to trade, enabling the market to determine if the shares have any value.

3.7 The exchanges should revise their criteria for delisting as required to enable this recommendation to be pursued. While the exchanges can currently delist a security for a variety of reasons[38], additional criteria should be examined. Examples of criteria that may be applied and are used elsewhere are:

- Discontinuance of business operations
- Material change in business not approved by the Exchange
- Minimum revenues
- Sustained lack of profitability
- Minimum trading price of shares
- Minimum public float of shares.

3.8 In addition, a more visible differentiation of stock lists by tiers is needed, especially at BSE and NSE. This helps investors to understand the size and significance of a company, based on the standards established for different tiers. The BSE and NSE should provide incentives for companies to graduate to the top tiers of their stock lists, such as providing additional services and reducing the regulatory burden in recognition of the lower risk of non-compliance with requirements.

3.9 If the mandatory regional listing requirement is eliminated, the lobby against scaling back the number of LCs should not be insurmountable, especially given that these companies account for a tiny fraction of market capitalization and trading volumes, and many are inactive. [39]

3.10 Concerns about the impact of delisting on the remaining shareholders of a company have significantly influenced regulatory policy on delisting. The reluctance to delist companies has given rise to the problems noted above. While there are several paths that a delisted company may follow, depending on its circumstances, the viability of the company and the merits of maintaining its status as a publicly-traded issuer must be considered. Arguably there is no

[37] About 1/3 of BSE LCs are in default on their listing fees.

[38] See, for example, chapter IV of the NSE Listing Regulations.

[39] There will still be stiff opposition to this measure from LCs since companies want to remain listed on BSE as a visible national exchange.

equity interest remaining in a company that is no longer carrying on an active business. Moreover, it serves the interests of a healthy capital market, as well as the stock exchanges' interest in market quality, to maintain reasonable standards for the continued listing of companies. Arguably these interests outweigh the interests of shareholders in maintaining the right, often theoretical if there are no buyers, to continue to trade a stock on the relevant exchange. Failed companies may go out of business, which is a risk investors assume in equity investments.

3.11 Delisted companies may continue to trade on another market, may cease to maintain the status of a public company, or may cease to carry on business. Some of the options that exist :

- Companies delisted from BSE could continue to trade on a regional exchange, if applicable listing requirements are met.
- If a company does not qualify for listing on any exchange, the shares could trade over-the-counter (OTC), meaning on an unlisted basis, if policymakers support the existence of an OTC market. However, OTC trading does not eliminate the market integrity problems noted above.
- The Department of Company Affairs may convert the company from a public company to a private company, either on application of an exchange or through another process.[40]
- If SEBI becomes the primary regulator for public issuers and maintains a list of registered companies, SEBI could also deregister a company, thereby making it ineligible for public trading. The criteria for making such a decision could be similar to the delisting criteria established by exchanges, such as failure to make required filings.
- The company may be wound up.

3.12 It should be noted that a company may delist voluntarily if shareholders vote in favour but promoters are expected to make an offer to shareholders who wish to sell their securities.

4. SEBI should expand disclosure requirements further in order to continue to improve standards of disclosure. SEBI should institute a disclosure review program to monitor and enforce disclosure requirements, including financial statements.

4.1 The revised securities law referred to in #1 above should provide for a comprehensive set of disclosure requirements, including all requirements currently set out in the DIP guidelines and the Listings Agreement. New requirements, such as those noted in point 7.3 above should be incorporated into the law, with a view to moving Indian requirements closer to best practices in developed markets.

4.2 SEBI has been pressing the Indian Institute of Chartered Accountants, which promulgates accounting principles, to improve local standards. SEBI has the authority to intervene if necessary, but does not have staff or resources to examine accounting standards. Indian accounting principles should be expanded to ensure consistency with IASC standards, and to address new areas of activity, such as securitizations and use of derivatives.

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[40] This can be done, for example, if the company has less than 50 shareholders.

4.3 Enforcement of existing requirements is a more fundamental issue than expanding the scope of the requirements. The Exchanges lack the powers and resources needed for a thorough and effective compliance program in this area, although their programs are definitely yielding improvements. In order to significantly improve compliance and impact corporate culture, especially below tier 1, SEBI must take proactive steps to raise the bar on disclosure, backed by effective sanctions.

4.4 SEBI, in cooperation with the exchanges, should institute a disclosure review program to monitor compliance with continuous and periodic disclosure requirements. The disclosure record of a subset of LCs should be vetted annually, and the appropriate follow-up action taken. Serious violations should be investigated for the purpose of taking enforcement action. Less serious problems might lead to a direction to the company to make additional disclosure, or restate its disclosure or financial statements.The general findings of the regulators should be published, including any guidance on best practices considered to be appropriate.

5. SEBI should implement a system of reporting trades by "insiders" (officers, directors and large shareholders) of LCs in a timely manner, in order to increase market transparency and combat manipulative practices.

5.1 There is currently no legal requirement for "insiders" to report trades in securities of a company they are involved with, except for holdings that reach the 5% threshold. The Listing Agreement was recently amended to require LCs to file reports on shareholdings of 5% or greater. However, non-compliance is apparently widespread (in part because the requirement has only been introduced recently). The existence of nominee holdings and lack of a central national depository complicate the matter, since responsibility for filing the reports lies with the company.

5.2 In order to combat actual and perceived abuses by insiders, including "promoters" and controlling shareholders of LCs, securities law should require all trading by insiders in securities of their issuer to be reported to SEBI, based on beneficial ownership of the shares. This information should be made public in a timely manner, as it is in the U.S. and some other jurisdictions. A system of electronic filing and generation of summary reports from the data should enable both reporting and disclosure to occur shortly after trades are made.

5.3 The trade reports should be used in the Exchanges' market surveillance programs to help identify potential violations of the law prohibiting insider trading based on non-public information.

5.4 Because of the widespread use of nominee accounts, and incentives to disguise ownership of shares, including the tax regime, stringent enforcement measures will be required in order for such a system to be introduced successfully.

Annex 4: SEBI Restructuring: Observations and Recommendations Related to SEBI

I. Summary

Although SEBI has become more effective in the past several years, it is deficient in several important respects. SEBI lacks credibility, and the community is regulates perceives it as weak. Without substantial restructuring and significant additional resources, we question whether it can be effective.

First, SEBI lacks transparency in key areas. SEBI's views on the types of market conduct that should be prohibited remain opaque. Key concepts are not defined, rules are not published in advance for comment and are often confusing, and enforcement orders are not public. This leaves regulated entities scratching their heads as to what conduct is prohibited. SEBI fails to publish even its own budget and financial statements.

Second, SEBI lacks strong governance. The SEBI board is a part-time board, which lacks experts from the securities industry. Rather it is composed of members from private industry and other government departments whose interests could be adverse to SEBI. Due to the structure of the securities laws, power to regulate the markets in fragmented among SEBI, the DCA, the ICA, the exchanges, and others. It remains unclear what role SEBI plays compared to these other bodies.

SEBI staff also could be more professional and highly trained. Although they have degrees in Business Administration, many lack securities experience. SEBI recruits from other governmental agencies -- particularly the tax authority -- for employees who serve short-term assignments and appear to lack interest in building a strong regulatory and enforcement body. Wages are two to three times lower than the private sector resulting in over 30 percent turnover.

Third, SEBI lacks adequate enforcement powers. A strong enforcement program is essential to a strong independent regulatory body. The real threat of enforcement sanctions deters market participants from engaging in misconduct and SEBI does not provide this threat. Although it has some enforcement powers, it cannot compel key information during its investigations from all persons. Although it may levy fines, it lacks authority to issue cease and desist type orders against all market participants and must often apply to the criminal courts to impose sanctions, which is costly and time-consuming.

Recommendations:

- Publish all important SEBI documents such as proposed new regulations before made final and the full text of orders in enforcement cases.

- Consider which key concepts remain undefined and publish proposed regulations to define those concepts.
- Consider proposals to restructure SEBI, such as amending the legislation that establishes the composition of the SEBI board to provide for full-time members drawn from the industry and academia.
- Consider proposals to provide a large capital infusion into SEBI to increase salaries substantially and purchase key resources such as office space and information technology. Consider eliminating certain clerical positions in favor of more professionals.
- Revise SEBI personnel policies to encourage it to promote from within and draw new employees from the industry. Avoid where possible deputizing officials from other governmental offices to work at SEBI for short periods.
- [Enforcement authority.]

II. Explanation

A. SEBI lacks transparency

- Key concepts. SEBI has not defined key terms and concepts that arise every day in the regulation of securities markets, including exchange, manipulation, insider dealing, misappropriation, fiduciary, and suitability. Moreover, Indian law lacks a well-developed body of case law or other interpretations of key terms. SEBI officials have expressed concern that because Indian law is not well developed, they have relied on US law to determine whether they should prohibit particular conduct. Since market participants do not view SEBI as a strong regulator, and the law is not clearly defined, market participants may engage in questionable conduct unless expressly prohibited.

  This became apparent in the aftermath of the market events of 2001. SEBI pointed to selling in particular stocks, coupled with significant declines in price, and stated that such conduct is indicative of manipulative conduct. Such statements, however, omit a key analytical step, which explains the particular conduct (beyond trading) that would suggest intent to manipulate the market.

- Procedures for adopting regulations. SEBI law is contained in the SEBI Act as well as 18-20 SEBI regulations. SEBI's procedures to adopt new regulations, however, generally include internal consultation only. Although SEBI has on occasion sought input from industry, this input appears arbitrary, and it does not include input from all firms or other market participants who may wish to have a voice. The process is perceived as arbitrary and capricious, and it damages SEBI's credibility.

- Procedures for enforcing the securities laws. SEBI employs a complex multi-step process that includes an order for a formal investigation issues by the Chairman, a report to the Chairman by the SEBI staff, a decision whether to appoint a an Inquiry Officer, a decision by the Inquiry Officer whether to issue a show-cause notice, a hearing before the Inquiry Officer, and a final hearing before the Chairman, who makes a final determination as to sanctions and issues an Order.

The process, however, is not transparent. Certain key documents -- such as the final Order issued by the Chairman -- are not made publicly available. This causes uncertainty in the law with respect to conduct that SEBI may believe violates the securities laws. Although SEBI often publishes a press release about an enforcement matter of its website, the information about a particular violation is skeletal. The relevant information in the press release, dated April 19, 2001, for example, at the conclusion of the investigation into manipulation of the scrips of BPL, Videocon and Sterlite, states only that brokers "acting on behalf of a common set of clients who were acting as a front . . . cornered large chunks of shares of Videocon, BPL and Sterlite" The press release goes on to say, "This cornering led to a price manipulation. The scrip prices rose substantially." This information is circular, and it omits key facts and findings that led SEBI to conclude that the manipulation had occurred.

- Information about SEBI itself. SEBI does not make publicly available information about its own budget. This will become increasingly important when SEBI becomes a self-funded agency. As SEBI urges market participants to become more transparent, it could enhance its credibility by making publicly available accurate information about its own funding and expenditures.

  SEBI could also make available information with respect to positive actions it has taken. SEBI, for example, has instituted a strict ethical policy with regard to investments by employees. SEBI prohibits employees from investing in equity or convertible debt. SEBI employees a Chief Vigilance Officer to oversee any irregularity by SEBI employees. SEBI has apparently investigated several employees for misconduct, who have left the agency. Making all of this information public would likely promote rather than harm SEBI's credibility.

B. SEBI lacks strong governance

- Composition and independence of SEBI's board. SEBI is composed of six board members, representing several constituencies, which detracts from its independence. A member of industry, for example, serves on the board of SEBI, which could present clear conflicts of interest. While many jurisdictions encourage experienced members of industry to serve on a government securities commission or board, they often require that the member retire, and sever ties, from his firm before sitting on the governmental board. Only under this approach can appropriate firewalls stop the flow of non-public information from the governmental body to the private sector body.

  Moreover, two members from the Government of India, and one from RBI, sit on SEBI, which presents other conflicts and detracts from independence. Members of government, for example, may be unwilling to promote high regulatory and enforcement standards, which in the short term could result in less willingness to invest in the capital markets. If SEBI is to be perceived as a strong, independent and effective regulator, it must eliminate pressures, which are external to its mandate investor protection and market integrity.

- SEBI lacks a clear mandate. **[Unclear who is conducting surveillance of exchanges and brokers, who is conducting investigations of brokers, and who is ensuring financial and non-financial disclosure by companies and funds].**

- Quality of SEBI staff. SEBI appears to have difficulty recruiting, training, promoting, and retaining high quality staff, which detracts from its credibility. SEBI has faced attrition of approximately 35 percent annually -- with most leaving SEBI to join intermediaries. This is in part due to SEBI's starting salaries (approximately Rs.10,000 or US $200 per month) compared to salaries of private sector firms, often three to four times higher. Although SEBI offers other benefits, such as subsidized housing and meals, and low interest loans, these incentives apparently are not adequate.

  SEBI also appears to have difficulty-recruiting employees with securities industry experience. Many SEBI staff are recent business school graduates or come from other parts of the civil service, particularly the tax department. While staff from the tax department may have experience conducting investigations, such experience is relevant only for one aspect of SEBI's work. They lack experience in market regulation and knowledge of the securities laws. Although market participants in many jurisdictions are more knowledgeable with respect to new financial products than regulators, this problem appears to be acute in India. Finally, SEBI hires senior staff from outside SEBI instead of promoting from within -- another source of high turnover.

- Resources. SEBI is lacking certain key resources it needs to have credibility in the industry. SEBI has power to conduct surveillance of exchanges and broker-dealer firms. SEBI began to rely on the exchanges to conduct surveillance around 1997-1998 when the amount of reports received from 24 exchanges became overwhelming.

  SEBI officials have expressed concern that they are unable to conduct adequate inter-market surveillance. This is in part because issuers list on multiple exchanges and broker-dealer firms trade on multiple exchanges. Neither SEBI nor the exchanges have a mechanism to view the entire position of a particular firm, or to observe the trading of a particular stock, across all exchanges. This problem was particular acute in the most recent market events in 2001. SEBI was required to examine positions of particular stocks on an exchange-by-exchange basis. SEBI could have been more effective in addressing these events quickly if it had composite data.

Moreover, SEBI has powers to conduct investigations, for example, but without proper resources, such as recording devices for statements that are supposed to be on-the-record and physical space – testimony rooms – in which to take statements, these powers are not meaningful.

C. SEBI lacks enforcement powers

- Lacks powers to compel in an investigation against all persons.
- Lacks powers to bring an administrative action against all person.
- Lacks ability or willingness to test certain powers in court.

D. Intermarket surveillance

- No mechanism to address companies listed on multiple exchanges and broker-dealers trading on multiple exchanges
- Acute problem in early 2001 – SEBI examined positions on exchange-by-exchange basis – no composite data
- Registration of broker-dealer firms – single identifying number
- Revise reports obtained from exchanges and brokers
- Provide for information sharing arrangements between and among SEBI and exchanges

E. Inspections, investigations, and enforcement

- Professionalize use of accountants
- Training of examiners
- Litigate SEBI powers in investigations
- Discuss cease and desist authority

F. Resources

- Long-term
  - i. Significant salary increases
  - ii. Budget for new facilities
  - iii. Enhance IT systems

- Short-term
  - iv. Equipment such as recording devices for testimony
  - v. Testimony rooms

G. Investor education and investor complaints

Recommendations:

For rulemaking: Publish proposed rules for public comment
Make available comments on proposed rules; for interpretations, allow NAL process

Rec's on procedures for enf.: Provide information to party investigated – such as Order initiating formal proceeding
Publish findings at close of proceeding, in addition to press release
Think about procedures like due process and atty present.

For SEBI internally: Have a hotline, let folks complain. How's my driving? Annual budget and Profit and loss statement

Annex 5: Oversight and Governance of Stock Exchanges in India

I. Exchange Oversight

A. Background

The regulation of the Indian capital markets relies, to a large extent, on the role played by stock exchanges, depositories and clearing and settlement systems. These entities perform various regulatory functions including surveillance of market conduct, prudential supervision of market intermediaries, and monitoring of listed companies. A number of these entities are self-regulatory organizations –that is they are mutual organizations with a mandate to regulate their members. Others perform regulatory functions that are delegated to them either explicitly –through recognition criteria or an understanding with the authorities –or implicitly as an inherent part of their commercial function. For the purposes of this discussion, the stock exchanges alone were considered. Depositories and clearing and settlement systems perform a valuable regulatory function but it is limited to their very specific commercial functions. Stock exchanges carry on a much broader regulatory functions and are, thus, more central to an understanding of the India regulatory system. In addition, the recent market distress in India has exposed the weaknesses in the exchanges regulatory role and the authorities have expressed an interest in re-examining role and structure of exchanges.

There are 22 exchanges currently operating in India. Broker-dealers may be members of one or more exchange and listed companies are often listed on more than one exchange. The National Stock Exchange (NSE), which offers trading on a national network of terminals, supports trading in securities that it does not list. Of the 22 exchanges, only the Bombay Stock Exchange (BSE) and NSE can be said to be major exchanges –the analysis relates primarily to those exchanges, which have been considered in detail, and the regional exchanges (as the other exchanges may be called) are mentioned only briefly.

Until recently, the BSE was organized as a traditional exchange, owned and governed by its members and thus carrying out self-regulatory functions as well as operating a market. The BSE is a very large exchange and has the highest number of listed companies (over 6000) of any Indian exchange. It rates among the top twenty exchanges globally as measured by transaction volume and market capitalization. Presently, the BSE is in a state of transition –the authorities have removed all broker representatives from its board and, although it is still owned by its members, the BSE is being governed by a board consisting of SEBI representatives and independent governors. Plans for demutualization are still unclear but proceeding.

The NSE is a relatively new exchange, having commenced trading in 1993. It was India's first fully electronic market and since its beginning has led the market in innovation. The NSE has been phenomenally successful in attracting order-flow and has managed in a short space of time to outstrip the BSE in this respect. The NSE is a not-for profit private company owned by twenty Indian financial institutions (including banks, insurance companies and mutual funds). Most of these financial institutions are, in turn, state-owned or state-controlled.

While most of the regional exchanges are very small, a few are large enough to cause concern –for example settlement failures on the Calcutta Stock Exchange contributed to the recent market disturbance. It is widely accepted (by SEBI and industry alike) that the vast majority of the regional exchanges do not attract a sustainable level of liquidity and will be phased out of the Indian capital markets in the short to medium term. The prevailing view is that what liquidity does come to the regional exchanges does so because of the ability to arbitrage settlement account periods. Because settlement account periods do not match (although this will change with rolling settlement) traders were able to maintain open positions by closing down a position on one exchange prior to settlement, simultaneously opening the position on another exchange. Financially, most of these exchanges appear to survive only by virtue of a requirement that companies maintain a listing in the region in which they are located. The transition to rolling settlement, which begins July 2, will eliminate the practice of maintaining open positions and will thus sharpen competition between the exchanges, especially between the NSE and BSE. The expected reduction of liquidity on the small exchanges will reduce their financial viability –however, as long as regional listing requirements remain in force these exchanges may continue to operate.

B. Findings

Regulatory role of the exchanges

Each of the exchanges, regardless of size, performs a regulatory role –primarily in the form of market conduct regulation and clearing and settlement risk management. The exchanges also have a limited regulatory role with respect to listed companies. The exchanges are a key component of regulation of the Indian capital market –given the very large size of the market **[note to draft: the paper should contain a big picture description of the size and character of the market]**, the number of market participants and listed companies, and the resource constraints of the regulatory authority (SEBI) the system should (and does) rely on exchanges as a cost-efficient means of regulation.

There are, however, some apparent inadequacies in the supervision of exchanges –as illustrated in the recent market disturbance. It appears that manipulative trading on the BSE and NSE prior to February 2001 precipitated an artificial rise in prices and a subsequent serious drop in March which caused serious market disruption. Further, the president or other board members of the BSE appear to have misused information gained from inside the BSE to their own gain, possibly contributing to the market drop. The Calcutta Stock Exchange apparently allowed a level of badla lending and under-capitalization of brokers that resulted in very serious implications for the exchange –a number of brokers defaulted on trades, causing insolvencies and shutting down the exchange for a number of days. The exchanges were unable to prevent these events and, in some cases, were unable to respond appropriately. SEBI appears to have done the most in reaction and its reaction to the dropping market and to some of these facts was not adequate (for example, banning of short selling and additional margin were early reactions –it is unclear what analysis supported these responses and it is clear they did nothing to contain the problems).

Finding: The exchange play an important role in regulating the Indian capital market –this role is appropriate, however, a number of weaknesses must be addressed if the role is to be continued.

Oversight program

The concept of oversight of exchanges is well-established in the regulatory system –the *Securities Contracts Act* and the *SEBI Act* contain detailed criteria for recognition of SROs and stock exchanges and provides for the review and approval of rules[41] and grants SEBI the authority to carry out inspections of exchanges. SEBI has the right to demand documents, compel testimony of exchange officials and can direct the exchanges to take particular action. SEBI can also direct the exchanges to adopt particular rules. These powers compare favorably to those of regulators in industrialized countries including the U.S., Canada and the U.K.

SEBI has instituted an oversight program which includes on-site inspections and periodic off-site reporting from the exchanges. SEBI representatives sit on the boards of both the NSE and BSE, as well as the regional exchanges and SEBI approves all independent directors on the exchange boards. While the formal requirements for adequate oversight of exchanges are clearly in place, SEBI's use of this authority appears to be ineffective (as evidenced by the recent market disturbance and market disturbances or scandals over the past several years). SEBI is now facing several challenges with respect to exchange oversight including possible expansion of the exchange's regulatory role and the demutualization of the exchanges. In light of these issues, SEBI's role as supervisor of the exchanges should be examined carefully.

Currently SEBI is obligated by statute to inspect every exchange every year. Given its limited number of staff, SEBI has reduced this to a combination of on-site and off-site inspections. The exchanges are required to respond to an annual questionnaire –the questionnaire is identical for all exchanges. The smallest of the exchanges are not inspected on-site. A number of exchanges are inspected once every two years (in addition to the reporting requirements including the annual questionnaire). The NSE and BSE are inspected annually although this may be a recent practice.

An on-site examination begins with the standard form annual questionnaire distributed to the exchange a month before the on-site examination. SEBI's SRO inspection team designates one officer to gather information all year long on a particular exchange. This information is used as background for the inspection, as well as for day-to-day

[41] For the purposes of this discussion the word 'rule' includes all regulations, rules, by-laws, guidance notes or the like.

monitoring. The average examination lasts 7 days and involves 5 SEBI staff. The 2000 inspection of the BSE, however, lasted 2 months. Examination reports are not often made in writing –however an informal exit meeting with exchange management is held with exchange's able to give feedback at that time. Written reports for the recent BSE and NSE examinations have been completed. It is unclear whether the exchanges were given an opportunity to respond in writing to the written reports and it is also unclear whether the reports were discussed with the BSE and NSE boards.

SEBI looks at all areas of the exchange during the inspection including corporate governance (an examination of committee and board minutes), listed company regulation (including a review of exemptions granted), market surveillance and risk management. SEBI also audits the financial records of the exchange using an outside CA firm. This audit includes a review of the use of the exchange's reserves and handling of member margin deposits.

In addition to annual inspections, SEBI requires exchanges to report daily information including statistics on turnover and margin. Monthly reports are also filed and these reports include status reports on investigations, details of material events and inspection summaries. SEBI also reviews and approves all exchange rules.

Focus of oversight

SEBI's oversight of the exchanges focuses on market conduct and settlement default. SEBI currently looks at trading in particular securities –SEBI reviews daily trading reports and daily reports on broker positions in a particular security. The on-site inspections also focus on the surveillance of market conduct and on broker positions. SEBI also exercises its authority by directing the exchanges to take particular actions – imposing additional margin for example –based on its monitoring of this information. This practice amounts to "surveillance of surveillance" and reflects SEBI's own view of its supervisory responsibilities.

SEBI does carry out full inspections of some of the exchanges and this includes corporate governance, technology, monitoring of listed company operations and the exchanges' financial operations. SEBI audits the exchange's financial statements even though the exchanges are required to file audited annual statements. SEBI cannot be criticized for the scope of its undertaking –although there is reason to believe the full scope of an inspection is inconsistently applied and full inspections have been only recent –but there are clearly shortcomings in SEBI's understanding of the role of supervisor. For example, SEBI staff explained that in its inspection of the market conduct surveillance function, SEBI inspectors recreate events and review the decision made by the exchange staff. SEBI inspectors may not agree with the exchange staff but, SEBI admitted, there is nothing that can be done at that point so the matter is often dropped. Rather than examining processes and detecting conflicts of interest, lack of resources or lack of skill, SEBI is examining particular fact scenarios. This is done also on a daily basis with SEBI becoming involved in day-to-day surveillance decisions. Another example is that of financial statement audit –this is a use of precious resource simply to double-check an independent audit.

The SEBI could better target the subject of its examinations –for example by considering the conflicts of interest the exchange may have when designing the oversight program or sources of revenue should be considered, sources of competitive pressure. Issues new to the marketplace such as the enforcement of governance policy by the exchange (internal policies and procedures on trading by employees for example) or technology issues could be included in the programs. The exchanges appear to experience SEBI as a constant presence in daily decision-making rather than as a supervisor and, unfortunately, do not appear to regard the outcome of inspections or other supervision as instructive.

There is no legislative limit to the scope of the examinations or oversight –SEBI has full authority to carry out an examination and may prescribe exchange rules or actions. It is unclear whether SEBI itself understands the broad nature of its role. For example, SEBI staff expressed concerns that exchanges are under-staffed and therefore unable to monitor market conduct and risk management effectively. This points to a lack of understanding as to the nature of the oversight role and a lack of practice in assessing how that role might be used to maximum effect.

Finding: SEBI oversight of the exchanges is formalistic and reactive. *SEBI does not focus its oversight efforts –rather it conducts formalistic annual reviews in a short period of time. Day-to-day involvement with the exchanges is often duplicative of the exchange operations (for example, examining surveillance data to add an additional level of market surveillance). There is little focus on understanding areas of risk or areas of new development.*

Inter-exchange co-operation and information sharing

There is little infrastructure in place to support sharing of information –there are no legal requirements nor mechanisms in place (memoranda of understanding between exchanges, for example) and no clear mechanisms for the exchange of information. Consequently, although many public companies are interlisted or have securities traded on more than one exchange there is little sharing of information with respect to these companies across the exchanges and there is no sharing of information with respect to investigations of company behaviour or investor complaints with respect to particular security. There is no requirements that a company disclose to the exchange that it has been halted or delisted elsewhere.

Similarly, although broker-dealers are members of more than one exchange, there is no sharing of information with respect to inspections of broker-dealers or enforcement and investigations proceedings being taken against them. The one exception to this general rule is that he exchanges do share information with respect to broker-dealer exposures to particular securities assessing settlement risk and applying margin requirements.

Finally there is no sharing of market surveillance information from the point of view of market conduct or trading improprieties (although surveillance of broker positions is shared). Because information is not shared, areas of concern may not be identified and, furthermore, regulatory action is not co-ordinated. The lack of information sharing was cited by both the exchanges and SEBI as a serious impediment to detecting market misconduct. SEBI has created an inter-market surveillance group consisting of itself and each exchange, which meets annually. This forum may be helpful for an exchange of information at a high level but it does not achieve detailed information sharing. It would appear that the exchanges have difficulty in developing trusting working relationships amongst themselves and this has inhibited even informal information sharing. This lack of trust is exacerbated by widespread leakage of confidential information at all stages of transaction reporting.

Finding: There is little sharing of information between the exchanges: *The exchanges do not share information with respect to investigations or inspections of brokers or listed companies. This lack of information sharing is a significant impediment to adequate supervision of the markets –it creates gaps in regulation and supervision and promotes regulatory forbearance.*

Demutualization of exchanges

In March 2001, the Minister of Finance announced a nation-wide "corporatization" of exchanges and banned broker representatives from participation in the governance of exchanges. Although the form of corporatization or demutualization is as yet unsettled and it is unclear whether this has been carried out at all regional exchanges, what is abundantly clear is that demutualization of exchanges is a policy direction the authorities will pursue. The implications of demutualization on market and regulatory structure are discussed elsewhere in the report. Despite these developments, there is no comprehensive approach to the demutualization of exchanges at SEBI nor does it appear SEBI has considered the implications of demutualization for its oversight program. SEBI staff expressed the unmitigated view that demutualization was 'good' and would produce no additional issues –indeed they believe that the change in governance structure will remove all concerns about conflicts of interest in the exchange. This view and the lack of a planned approach underscores a lack of understanding of the complexity of demutualization and will leave the exchanges and SEBI unprepared for full demutualization.

Demutualizations will require an adjustment of oversight priorities (over and above an adjustment to address existing weaknesses). The exact details of SEBI's oversight program will depend on the extent of demutualization –whether or not exchanges become truly publicly held or whether the exchanges become for-profit companies. A future opening of competition would challenge the oversight program even further.[42]

[42] Currently alternative trading systems are not contemplated by SEBI rules and foreign exchanges do not operate in India. It is unclear whether this is prohibited by law but it is almost certainly prohibited in practice. There is a potential for domestic competition, however –SEBI currently has 4 pending applications for recognition of an exchange.

Demutualization will require a different focus on oversight of governance –with SEBI paying special attention to new conflicts of interest that arise –in this case the conflict between commercial concerns and regulatory obligations. In an increasingly competitive environment (even between the NSE and BSE for example) SEBI must re-examine its "hands-on" approach to rule making since it now often imposes rules on exchanges, reducing the exchange's flexibility and creativity which will be more problematic under commercial strain.

The on-going role of brokers should be considered and a well-considered approach taken –the current demutualization effectively shuts the brokers out of all decision making on the exchange. This results in a serious loss of expertise for the BSE, for example. The NSE has managed this issue by including brokers on a number of its committee, thereby gaining input from the exchanges. There are many other issues including restrictions on ownership, on-going financial viability of the exchange if it becomes for-profit (there may be a level of discomfort at the idea of either the BSE or NSE going out of business and in any event if one of them were to wind-up the process would have to be managed in a way least disruptive to the market). The concept of self-listing of a for-profit exchange should be considered and planned for.

Finding: SEBI has not examined the implications of demutualization on its oversight of exchanges. *SEBI appears unprepared for changes to governance structure, competitiveness and priorities that will result from demutualization. SEBI appears not to appreciate the complexity of demutualization.*

Wind-up of exchanges

The failure of exchanges is the likely outcome of the transition to rolling settlement and a potential outcome of the demutualization of exchanges. It is likely that a number of small exchanges will cease to be viable in the short-term due to falling liquidity –the national presence of the NSE, the move away from regional listings and the harmonization of settlement account periods will reduce low liquidity even further. The articles of the exchanges allow for wind-up but this has never been done, even in the case of exchanges will very low levels of activity.

In addition to the problem of small exchanges winding-up, under full demutualization SEBI must consider the possibility of a major exchange becoming insolvent and must plan for such an event. For-profit entities facing competition for liquidity may find financial difficulties unheard of for not for profit mutual association exchanges. It is not clear that SEBI is in place to manage this process and to deal with the migration of listings and liquidity that may have to take place.

Finding: SEBI does not have a plan in place to manage the failure and wind-up of exchanges.

Exchange rule-making

Exchanges are required to submit rules to SEBI for review and approval. SEBI also has the authority to direct an exchange to enact a rule and this seems to be a reasonably frequent occurrence, if not the primary source of exchange rules. The proposed exchanges rules –those proposed by the exchanges themselves and those proposed by SEBI –are not published for comment as a matter of course. The exchanges or SEBI may consult with industry (through committees, for example) in the development of policy but there are few requirements with respect to the transparency of the exchange's process. Similarly, SEBI's approval or rejection of a rule is not published and, furthermore, there is no publication of SEBI's direction to create an exchange rule. This lack of transparency results in a loss of credibility for the rule-making process –particularly in terms of SEBI's involvement. SEBI is seen to be using its own rule-making ability and its ability to compel the exchange to enact rules in a way that completely controls the rule-making agenda. This is partially motivated by a desire to make sure all exchanges have a similar standard but this could be achieved through a transparent rule review process. It should be noted that the exchange's annual reports are publicly available.

Finding: The exchange rule-making process is not transparent. *There is no practice of publishing exchange rules for comment or publishing SEBI approval or rejection of those rules or of publishing SEBI imposed rules for comment.*

Regulatory role

There is a lack of clarity regarding the regulatory role played by the exchanges and SEBI, which appears to have resulted in non-action on the part of both. This lack of clarity extends to the role of other agencies. For example, the exchanges are unclear what their role should be with regard to listed companies. While the exchanges would like to delist inactive companies and refuse listings if a prospectus does not meet with their standard but they feel a limited power to do so. They also feel a limited power to enforce governance and disclosure requirements. Theoretically the listing agreement could encompass all of this but the exchanges have not successfully negotiated their role with SEBI and SEBI has not made clear what it believes the various roles should be. Complicating the situation is the role of the Department of Company Affairs, the agency responsible for enforcing the Companies Act and the agency with the power to bring many of the necessary actions against companies. In the case of broker-dealers neither the SEBI nor the exchanges carry out adequate regulation of subbrokers or brokers.

Finding: The regulatory role of the exchanges is not clear. *There are many areas of overlap –for example between the SEBI and the DCA –that prevent a clear delineation of duties. In some areas –regulation of subbrokers for example –no agency has taken responsibility for regulation. As a result exchanges are left without clear direction as to the limits of their jurisdiction or to whom they should turn for support regarding listed companies or market participants.*

C. Recommendations:

SEBI's approach to oversight must be refocused

SEBI has been carrying out an oversight program for five years and its success can be questioned by the poor state of India's exchanges. SEBI must focus on its role as a supervisor and avoid formalistic and duplicative oversight processes. SEBI's role should not be one of second-guessing exchange decisions but rather a role of ensuring that the exchanges have the capability to carry out their regulatory functions in a fair and adequate manner. Rather than visiting every exchange annually for a short visit SEBI should target its resources to address particular issues at particular exchanges. SEBI inspectors do review background information and prepare for the inspection but this has to be significantly improved so that clear risks or areas of concern are identified and an inspection program is tailored to address those risks. Staffing of the inspections should relate to the areas of concern (for example, currently there are no corporate finance staff involved in exchange inspections –if the concerns are with respect to handling of listed companies, such staff should be included). The constraints on the current system (large number of exchanges, large number of issues, limited staff resources) has lead to pro forma inspections that do not add value but rather fulfill a checklist of items. The reports should be in writing and SEBI should consider making the reports, or a summary of them, available to the public as a means of boasting public confidence in the exchanges. The exchanges should have an opportunity to respond in writing to the reports.

As a replacement for duplicative analysis of trading or decisions made on trades, the SEBI should consider joint inspections or joint investigations with the exchanges as a means of pooling resources, sharing expertise and ensuring that such operations are properly carried out by the exchanges.

Finally, the SEBI annual report should include a summary of SEBI's oversight activities.

SEBI must plan for demutualization and develop its oversight program accordingly.

SEBI must develop a greater understanding of the issues that will be raised by demutualization and must be prepared to facilitate exchange reorganizations. SEBI must be prepared to adjust its oversight processes to allow exchanges to operate in a competitive environment. SEBI must open a dialogue with the exchanges regarding demutualization process and its impact on oversight.

SEBI must develop a process for winding-up of exchanges.

Exchanges should be required to share information.

SEBI should require the exchanges to enter into information sharing arrangements regarding inspections, investigations, listed companies and market surveillance. It should be clear that if the exchanges do not come to such arrangements within a reasonable period of time, the arrangements would be imposed by SEBI. However, this should be a measure of last resort.
Information sharing should include: information with respect to listed companies, broker-dealer exposures to a particular issue, open investigation of members with cross-

membership, and customer complaints. Exchanges should enter into information sharing arrangements that enable them to share confidential information on a timely basis. The process for coming to such arrangements might be slow and difficult given the lack of trust between the exchanges in the current environment.

Exchange rule-making should be transparent.

SROs should have the ability to promulgate rules in an efficient and expert way, building on their expertise and proximity to the market and market participants. All of the exchanges have this ability. SEBI reviews and approves rules and can direct the exchange's to create rules, providing oversight and supervision. However, there is still a lack of accountability in the process since there is no transparency to the public. The exchanges should be required to publish rules for comment and SEBI should be required to take those comments into account. SEBI's approval or refusal to approve should also be published and should SEBI direct rules to be made this should also be subject to publication for comment. Of course, there are circumstances in which a publication requirement may be unnecessary –for example for minor administrative rule changes or in cases of emergency –provisions for these exceptions should be clearly set out in a SEBI rule and in exchange by-laws. In these cases there should be a post-adoption publication requirement.

In publishing for comment the exchanges and SEBI should be required to fully explain the proposed change, explain the reasoning supporting the change and the connection between the proposed rule and the exchange's regulatory functions. A comparison between the proposed rule and rules of other exchanges (domestic and foreign) and a reconciliation between the proposal and existing rules could be required.

The exchanges role in regulation should be clarified.

Currently there is a gap in regulation of both listed companies and broker-dealers –there is little regulation of listed companies beyond the initial prospectus and it is unclear to the exchanges whether they should pursue continuous disclosure or corporate governance issues and there is no regulation of broker-dealers beyond the management of the risk the dealers may pose to the clearing and settlement of trades on an exchange. These issues must be addressed coherently. If the exchange's take on additional responsibilities, SEBI must be prepared to provide support in the form of enforcement actions and rule making. If SEBI takes on the additional roles then the need for greater resources and efficiency must be carefully considered.

II. Exchange governance

A. Background

For the purposes of this report, the governance of the BSE and the NSE alone were considered. Many of the findings and recommendations will be applicable to the regional exchanges who, like the BSE, have recently been required by the Ministry of Finance to eliminate broker-dealer representatives from their boards and have begun to consider full demutualization.

B. Findings

BSE and NSE boards

Prior to the Ministry of Finance decree in March 2001, which came as a result of the market crisis although the issue had been considered for some time, the BSE board consisted of 19 representatives –9 elected by members, 3 SEBI representatives, 1 RBI representatives, 5 independent representatives approved by SEBI and the executive director. The board now operates with 10 representatives, having lost the 9 elected by members. It is acknowledged that this is a transitional arrangement and that once a plan for demutualization has been approved by the Ministry of Finance the board composition will change. The BSE has a number of standing committees, in accordance with its bylaws, which were also formerly staffed by a combination of member-elected representatives and independent directors approved by SEBI. However, SEBI took the view that it could not be directly involved in these committees since there would be a conflict of interest between participating in day-to-day decisions at the exchange and acting as supervisor of the exchange. It is the member's role at this level that has been widely criticized since these committees made disciplinary decisions and had access to confidential information such as information with respect to broker positions. In addition, previous to the scandal the chief executive officer was also a trading broker –however he was dismissed and now a full-time non-trading executive director heads management.

The NSE is owned by 20 financial institutions, all non-members. Its board consists of elected representatives, none of whom are brokers. It has an executive committee consisting of Board members and some broker representatives. This committee makes decisions on interpretations of rule and administrative issues –it is a clearing house for all major decisions which are put to the Board. The Board makes all final decisions with respect to new rules. Disciplinary and default decisions are made by committees that do not have broker representation.

Through its board membership SEBI is able to force discussion and vote on items at the various boards. Combined with SEBI's frequent use of its ability to impose rules and actions on the exchanges, the result is that SEBI's policy agenda is executed through the exchanges directly.

Finding: The exchange boards do not operate with sufficient independence. SEBI representatives constitute a majority of the Boards of the exchanges, as was the case even before some exchanges were forced to expel brokers from their boards. SEBI is represented directly and also approves and appoints the independent directors.

Codes of conduct

The NSE has developed a code of conduct for its board of directors including disclosure of interests and restrictions on trading. Confidentiality of information is protected because members are not allowed to sit on the board. SEBI has drafted a code of conduct for elected directors for the remaining exchanges. The BSE is considering adopting this code (as prescribed by SEBI) and proposes to extend it to all directors. The code will prevent board members from trading even for personal accounts. It is clear from the events of February and March 2001 that the role of directors has not been well handled on the BSE but the composition of the board has changed and indeed is still in transition. The BSE appears to regard corporate governance as a significant issue under demutualization.

Finding: Corporate governance policies on the exchanges need to be refined and enforced. The exchanges have recently turned their attention to conflict of interest policies for board members and employees, codes of conduct for board members and employees including restricted trading and disclosure of holdings, and confidentiality of information. However, these efforts are in the early stages and this area remains an area of considerable concern.

Finding: Although steps have been taken, particularly at the NSE, to separate the board and day-to-day management, these roles are not clear.

Quality of directors

The exchanges have not, traditionally, given much consideration to criteria for choosing directors –it appears that in the case of independent directors, most have been chosen by SEBI. The quality of directors will be crucial in improving governance of the exchanges and allowing exchanges to effectively balance regulatory obligations and commercial aspirations. The current focus on corporate governance in public companies in India suggests that sensibilities are changing and there is widespread acknowledgement that sound corporate governance is a competitive business issue as well as a regulatory concerns. In the case of exchanges, demutualization and/or increased competition following rolling settlement will add to the pressure to improve corporate governance. Attracting quality directors is one important aspect of improved corporate governance. The current situation, with the over-involvement of SEBI in day-to-day affairs and lack of consensus on the role of the exchange, will be an impediment to attracting quality directors –for example, it would be a daunting task to take on governance of the BSE in its current state of uncertainty.

Finding: Exchange board quality must be improved The exchanges are in a transition period with full-demutualizations being considered but not yet carried out. However, it is clear that board quality has been a serious issue in the past with poor governance undermining the exchanges' ability to carry out its fundamental regulatory obligations.

Role of brokers

The current governance and operational structure of the BSE does not allow for input from the brokerage community –brokers cannot sit on committees or the board, rules are not published for comment or routinely circulated to the brokers for comment and new policy is not discussed with the industry. The NSE includes brokers on committees and in the policy and rule-making process although brokers are not involved in enforcement or default decisions.

Finding: The future role of brokers in demutualized exchanges is unclear. The MoF decree has excluded brokers from any involvement in the BSE. At the NSE brokers are involved in policy making and decision making at the committee level. BSE management are concerned that exclusion of brokers results in a loss of valuable expertise and input.

C. Recommendations

SEBI representatives should not be on the exchange boards: SEBI should continue to exercise close oversight of the exchanges but the involvement of SEBI directly on the boards of exchanges creates the appearance that SEBI is directly responsible for the day-to-day decisions made by the exchange –this is at conflict with its role as supervisor of the exchange. This is particularly true now that the broker representatives no longer sit on the boards of exchanges –leaving SEBI and public directors on the Bombay Stock Exchange, for example. It is interesting that SEBI removed itself from the committees of the BSE and NSE, which make day-to-day decisions because of a perceived conflict but did not think this extended to the full board. Of course, finding quality non-broker board members will be quite challenging but this should be a priority for the exchanges.

Brokers should have an on-going relationship with the exchange: The current state of affairs whereby SEBI representatives alone sit on exchange boards (other than the NSE) cannot continue. SEBI and the MoF will have to carefully consider board composition under demutualization. However, even under a demutualized regime, the authorities should not disallow all broker involvement on committees or even boards. The exchanges should be permitted to include brokers in decisions and policymaking other than those related to discipline and default. Brokers should also not have involvement in day-to-day operations and should not have access to confidential information. Broker expertise is, however, crucial to the exchange's ability to formulate business planning and to bring in effective rules.

The role and functioning of the board and management should be clarified: The exchanges should have clear policies as to which issues will be managed by staff and which by the board. The board should deal with business and strategic issues which the day-to-day management and regulation should be carried on by staff. Involvement by the Board in regulation should be limited (approval of rules and policies, status reporting on a summary basis or acting as the disciplinary board).

Demutualized exchanges should focus on attracting qualified and independent directors: While this will be very difficult in current circumstances it is of primary importance. An independent director will be one without shareholdings in the exchange, without a financial interest in the exchange or any member of the exchange, either direct or indirect. Directors should have clear fiduciary duties and should be liable for their actions –this will require a more refined code of conduct and, more importantly, enforcement of the code of conduct. Directors might be permitted to trade for their personal accounts but should disclose all trading on a monthly basis. This disclosure should be made to SEBI.

Box 1. Exchange governance – country experience

Governance of exchanges has been a hot topic among regulators in recent years. As regulators began to hone their supervisory roles, it has became clear that the key to the effective use of exchanges as regulators was sound corporate governance. The most dramatic example of this new focus came with the 1995 enforcement action taken by the U.S. Securities Exchange Commission against the National Association of Securities Dealers (NASD) the operators of the Nasdaq market. The SEC found that inadequate corporate governance had allowed the large market makers on Nasdaq to virtually control the market place and impose anti-competitive artificial spreads. One of the outcomes of the enforcement action was a restructuring of the relationship between the market and the members. Along with the separation of the NASD from Nasdaq came a requirement that 50% of the members of the boards of each of the NASD, NASD Regulation and Nasdaq be independent of members. These independent members are drawn from professionals (lawyers, accountants etc.) with expertise in the area, financial institutions that are not members of the NASD (mutual funds, large institutional investors, banks etc.) and public companies. The US SEC has also required the New York Stock Exchange to have a 50-50 board –with 50% of board members independent of members and drawn from backgrounds similar to NASD independent board members. This 50-50 requirement is extended to key committees. In Canada a similar pattern has been followed. The demutualized Toronto Stock Exchange has a 50-50 board as does the Montreal Exchange and the Canadian Venture Exchange.

Annex 6: Market Surveillance In The Indian Capital Markets

I. Background

A. Key Findings

1. Surveillance of trading on the Indian exchanges is very fragmented, with each exchange looking only at its own market. There is minimal cooperation and sharing of information among the exchanges. This means that:

- **Cases are not being investigated that otherwise might be if all relevant trading was being examined at the SRO level;**
- **Cases are not being referred to SEBI that otherwise might be if exchanges investigated the full picture;**
- **SEBI is receiving referrals of unconsolidated files from various exchanges, in different formats, which are difficult to consolidate.**

1.1 Given the fragmentation of Indian markets, with issues trading on multiple exchanges, the shortcomings of the regulatory system are serious. The problem is exacerbated by the fact observers agree that manipulators attempt to disguise their activities by trading through multiple brokers on multiple exchanges, using various nominee accounts. Investigating cases of this level of complexity requires sophisticated and centralized regulatory systems and programs.

1.2 Currently the onus for consolidating surveillance information lies with SEBI, which receives reports from all relevant exchanges when carrying out an investigation. Since this consolidation occurs after the fact, when an exchange refers a matter to SEBI or SEBI identifies a need to investigate a matter, this approach suffers from significant shortcomings. The analysts monitoring the market on-line, and following up on alerts and exception reports generated in the course of monitoring, should have access to a complete picture of trading activity in order to carry out a fully effective surveillance program. Certain problems may not be identified when trading on only one exchange is being reviewed. Even if a problem is noted, the analysis and investigation of the matter would be more effective if the analysts have access to complete information about the trading activity in question. Referrals to SEBI would then be more useful, and the investigation should be advanced to a further stage by the relevant Exchange or Exchanges.

1.3 Because SEBI does not carry out direct, front-line market surveillance, its approach of consolidating data at the investigative stage is not, in itself, an adequate response to the fragmentation problem. A consolidated picture of the market is needed for front-line surveillance, not just for the investigative stage. We do not advocate SEBI taking on the front-line surveillance role. It is not necessary for SEBI to assume the Exchanges' surveillance functions, and given the resources required and the fact that the NSE and BSE have effective surveillance staff, systems and databases in place, the most efficient approach is to build on their existing programs, and have SEBI focus on improving its ability to investigate and prosecute violations.

1.4 SEBI and the Exchanges do have a mechanism in place to coordinate Market Surveillance programs and issues under the auspices of the "ISG" forum. However, the nature of this initiative needs to expanded significantly, and direct, continuous cooperation and information-sharing among the exchanges is required. In order to foster effective cooperative relationships amongst the regulators, including the Exchanges' surveillance staffs, organizational changes are required at all the Exchanges to clearly delineate regulatory staff from the trading business, because the latter is obviously competitive. It is imperative that confidential information shared for regulatory purposes not be available to the business side of the Exchanges, where it might be used for competitive purposes.

2. SEBI lacks the investigative and analytical systems, processes and human resources needed to effectively analyze trading across all of the exchanges and to thoroughly investigate problems referred by the exchanges, or that otherwise come to SEBI's attention.

2.1 SEBI has dedicated market surveillance staff with access to basic computer software programs and databases. However, the tools and information available to SEBI staff are deficient in several respects. Staff lack access to consolidated trading information across all exchanges, and must produce a consolidated picture for each investigation from data submitted by the exchanges, which is not submitted in a standard format. The analytical tools available are rudimentary, as is the range of data and information accessible electronically. There is also no computerized case management system to facilitate investigations and management of workflow.

2.2 It is evident that SEBI lacks the resources to effectively carry out complex market investigations. Rather than duplicating the Exchanges' on-line monitoring efforts, additional resources at SEBI should be focussed on its core functions of investigations and enforcement. In addition to enhanced software and information tools and expanded staffing, the Market Surveillance staff should receive additional training in investigative techniques and procedures.

3. BSE and NSE have computerized surveillance systems that generate a number of on-line and off-line alerts, and maintain surveillance units with qualified staff.

3.1 Both the NSE and the BSE have introduced automated surveillance systems and tools that alert analysts to unusual trading activity which may indicate some type of market abuse requiring regulatory intervention. Like many other Exchanges around the world, these tools identify anomalies in trading volumes, prices and patterns, and operate in real-time. They also enable users to view trading data in a graphical environment and to "drill down" their analysis of trading in specific securities.

3.2 Alerts are followed up quickly. For instance where the disorder appears to be associated with leakage of corporate information companies are immediately asked, by fax, to provide a statement clarifying the real position. That statement will be posted to each Exchange's website as soon as it is received from the company. (Unfortunately companies often take hours to respond.)

3.3 Surveillance staff dealing with alerts also require access to additional sources of information, which may shed light on the reasons behind unusual market activity. Some of these sources would include access to commercial news vendor feeds, corporate information sources and the increasingly influential web based channels of communication. At NSE the usefulness of their alert generating application is, to some extent, undermined by the fact that staff responsible for dealing with the alerts that are generated have access to public information only. Their view of the order book is the same as every other market participant. Therefore they do not see the identities of the firms placing orders. With the introduction of client identifiers the need for access to non-public data will become even greater. Apparently NSE Surveillance staff are not allowed access to confidential databases because the NSE tries to keep the number of its staff with access to sensitive data to a minimum. However, in our view access to all available data is essential to effective market surveillance. This applies to both alert generation, and review and investigation of alerts.

3.4 As noted in 1 above, the Exchanges do not have access to consolidated trading information across all exchanges. Databases and alert systems are based only on trading at the particular exchange. In a fragmented market, the inability to see the full picture of trading activity across all markets is a significant shortcoming. Similarly, alerts and follow-up reviews and investigations are generated based on a partial view of trading activity.

3.5 It is vital that surveillance staff who must react to alerts, and who make judgments about the need for follow-up or regulatory intervention, have the necessary background, training and skills. Our team did not have the opportunity to make a detailed assessment in this area, but we were impressed with the staff's enthusiasm and technical skills with the surveillance applications at BSE and NSE. Staff within the Surveillance areas of the two Exchanges appear to be very competent at using the applications and data sources already available to them. Where staff do seem to be in need of training is in some of the "bigger picture" issues. Market Surveillance units appear to be very focused on their specific responsibilities. An understanding of the overall market and corporate picture is important to effectively carrying out these functions. This focus seemed to lead to failures in terms of the way priorities were allocated.

3.6 Surveillance staff seem to be more remote from the market and its participants than is the case with regulators in other markets, who try to stay close to market activity and participants. This approach seems to stem from concerns about potential corruption and unauthorized access to confidential information. Such concerns are quite legitimate; however Surveillance programs that are remote from the market and its participants, including brokers, tend to be less attuned to market events and therefore are less effective.

3.7 BSE's and NSE's main emphasis appears to be on seeking to detect manipulative "circular trades", where brokers undertake "crossing transactions" which involve no real change in beneficial ownership, and on concentration of activity in certain brokers. The purpose would be to create the illusion of liquidity so that other investors will be tempted into the stock thus driving up the price to an unnaturally high level. The Exchanges pay little attention to the detection and investigation of "insider dealing". In the absence of anomalous price volatility in the period immediately before the release of a major corporate announcement, no monitoring or investigation of insider trading appears to take place.

3.8 Staffing of Market Surveillance functions at BSE and NSE appears to be in line with international standards.

4. Shortcomings in corporate disclosure, particularly the timely release of price-sensitive information, compromise Surveillance efforts and the ability to prevent insider trading and other abuses.

4.1 A close relationship exists between the effective functioning of corporate disclosure and an effective market surveillance program, because the prompt availability of full and accurate information about issuers leads to a more efficient market with more accurate pricing. This in turn makes market surveillance systems that target price anomalies more effective. Furthermore, a significant aspect of surveillance programs involves checking unusual trading against corporate news, in order to assess whether reasons exist for the unusual activity. Without an effective disclosure regime, it is difficult to verify market activity in this manner. In addition, obviously opportunities for insider trading and market manipulation increase if price-sensitive information is not announced in a prompt and accurate manner.

B. Recommendations

1. In order to ensure effective surveillance of trading activity across all markets, the Exchanges should either:

- **create a jointly-owned SRO subsidiary to carry out their self-regulatory responsibilities that would carry out market surveillance and investigations on a consolidated basis across all exchanges; or**
- **create a shared system to consolidate trading data across all exchanges for market surveillance purposes, and enter into a cooperation agreement to ensure the effective surveillance of markets, and investigation of potential violations.**

1.1 The issues involved in mandating and creating a national SRO that merges the regulatory operations of all exchanges are addressed in Annex *xx*. Ultimately, the decision on the preferred structure for the SRO system in India going forward will dictate which of the above approaches to Market Surveillance will be pursued. Since any changes to the SRO structure will likely take some time to implement, steps should be taken immediately to address the fragmentation issue and improve market surveillance, along the lines of approach ii) above.

1.2 The model for approach ii) is the international Intermarket Surveillance Group (ISG). The ISG operates on two levels: first, among all of the US stock markets to coordinate market surveillance and investigations across all of the markets; second, among the US stock markets and a growing number of exchanges around the world to similarly share information and coordinate investigations and other market regulation activities. In the US, where securities also trade on multiple exchanges, the ISG has created ISIS (Intermarket Surveillance Information System), a database that consolidates trading information for all of the exchanges. The ISG employs the concept of a primary investigating exchange to coordinate investigations across markets.

1.3 The consolidation of the Exchanges' surveillance systems would logically extend to development and support of one set of surveillance software for alert generation, integrated databases, and implementation of uniform processes and procedures in the exchanges' surveillance programs (if a consolidated SRO is not created). This approach would not only ensure consistency in delivery of regulatory programs, it would yield cost-savings in the development and maintenance of surveillance infrastructure.

1.4 In summary, cooperation among the Exchanges on market surveillance should extend to:

- development of a shared, real-time consolidated database of trading activity;
- continuous information sharing on surveillance issues and activity;
- a protocol for dealing with joint investigations and eliminating overlapping work;
- information sharing on investigations;
- coordination of surveillance and investigative processes and procedures;
- joint development and support of surveillance systems and databases.

2. SEBI should oversee the Exchanges' actions pursuant to #1 with a view to ensuring effective implementation.

2.1 SEBI should perform a coordinating and oversight role to ensure that the Exchanges cooperate effectively towards the objectives set out above. SEBI's role should encompass the development of market surveillance systems, investigative procedures, format of investigation reports, parameters for referral of matters to SEBI, and the overall resourcing and staffing of Surveillance functions by the exchanges. See Annex *xx* regarding SRO oversight.

3. SEBI should develop the systems and human resources necessary to effectively follow up on market investigations referred to them.

3.1 Since the exchanges' jurisdiction is limited to their members, any matters requiring investigation of clients or other market participants must be referred to SEBI. Given the apparent prevalence and complexity of manipulations involving multiple participants, robust analytical and investigation systems, skilled professional staff, and continuous training programs are required.

3.2 Our findings indicate that SEBI requires additional resources for its surveillance and investigations programs. Weaknesses exist in several areas, including:

- Inadequate staffing
- Need for training programs, particularly in procedures for carrying out complex market investigations
- Inadequate computerized support tools, such as investigations support, trade matching and case management systems
- Lack of electronic access to all relevant sources of information.

3.3 SEBI should report back to the Exchanges' regulatory arms, on a confidential basis, their conclusions on matters referred to them, using the ISG forum.

4. Detection of Insider trading should be a higher priority.

4.1 The Exchanges should place more emphasis on deterring, detecting and investigating insider dealing. The release of significant, price sensitive announcements by corporates, particularly in the more liquid stocks, should prompt a review of trading activity during the period leading up the announcement with a view to identifying trading by persons with access to non-public information, particularly officers, directors and promoters of companies.

4.2 Implementation of this recommendation will require new surveillance systems and procedures, including a system to electronically collect information from brokers about the identity of clients making trades the Exchanges are reviewing. The process being employed by Exchanges to detect and investigate insider trading should be overhauled, using best practices in developed markets, customized to the local environment in India. This would include alert systems to detect potential insider trading, compilation of information about trades being reviewed, obtaining relevant information from the company, and investigation and analysis processes. For example, exception reports connecting news releases and insider trading reports (if adopted as recommended in Annex xx) with trading activity might be employed. Information about the events and individuals involved during the period leading up to the announcement should be obtained from the company.

5. Market Surveillance staff should have electronic access to a broader range of information.

5.1 Market surveillance staff should have access to all non-public transaction information, including intraday transaction information detailing the broker participant, their capacity and the relevant client identifier. This will ensure that their regulatory judgments are made on the basis of comprehensive information. There is a risk that access to confidential regulatory information may be abused by regulators. Steps should be taken to ensure that regulatory staff cannot abuse their position and are subject to a stringent code of ethics. All regulators' telephone calls should be recorded, the use of mobile phones from within regulatory areas banned and all staff should be required to sign an agreement detailing the consequences of inappropriate use of confidential information or other breaches of the code of ethics.

5.2 Telephone calls in Market Surveillance should be recorded for a second reason too. Calls between surveillance staff and brokers should be recorded in order to provide a record of advice and directions provided by the Exchange, and responses from brokers to regulatory enquiries made by telephone.

6. The Exchanges should focus Surveillance resources on priority risk management problems, and initiate training programs to equip staff to address these problems.

6.1 Regulatory authorities should identify priority regulatory problems, such as price manipulation in particular types of stocks, and focus market surveillance programs and resources on identifying the problems and enforcing applicable rules. The current Surveillance programs appear to be focused largely on processes (eg. identifying price volatility or concentration of activity), as opposed to focusing on solutions (eg. preventing price manipulation or insider trading). Real-time monitoring using on-line systems is relatively sophisticated; however greater emphasis must be put on identifying violations and misconduct based on these alerts. This requires greater emphasis on follow-up and investigation.

6.2 Training programs should be instituted for Market Surveillance staff to equip staff with the expertise, skills and procedures needed to effectively address prioritized regulatory problems. Such training could take the form of a technical assistance program to introduce international best practices in the identified areas to front-line staff.

7. The implementation of mandatory use of client identifiers (Ids) needs to be managed carefully to be effective.

7.1 Insider dealing, market manipulation and circular trading are all much more easily diagnosed if the analyst can quickly identify the person responsible for each trade; ie. the identity of the broker and the client involved. Therefore, the proposed introduction of mandatory use of client Ids for all trades can be a significant reform, especially given the degree of fragmentation in the markets (ie. use of multiple brokers and exchanges). However, there are several practical obstacles to the effective implementation of the requirement, including use of nominee accounts, lack of supervision of brokers, the existence of sub-brokers, and so on. SEBI should actively oversee the implementation of the client ID system, in conjunction with the Exchanges.

7.2 Brokers should be required to complete the client identifier field in a consistent way at each Exchange, so trades in different markets can quickly be matched. Each client code should be unique to an individual client of the firm. Where the client is a sub-broker, acting as agent, then that client identifier must relate to that sub-broker's individual client. In addition, an effective system of broker supervision for compliance with regulatory requirements (beyond financial and margin rules) needs to be introduced, as recommended elsewhere, in order to ensure monitoring of compliance with the new requirement.

7.3 There are two alternative approaches to developing the capacity to relate a client identifier back to the actual investor:

- On each occasion the Exchange requires a firm to provide information about its client that information could be captured in a "Client Identifier Database". Over time the Exchanges would "learn" about the clients associated with each identifier.
- The Exchanges could require all brokers to provide a list of all client identifiers for active accounts, with the associated client details, and incorporate the information into a regulatory database

8. The timely and thorough disclosure of price-sensitive information by corporations is vital to the efficient functioning of markets, minimizing insider trading and other abuses, and effective market surveillance. (See annex *xx* on regulation of listed companies.)

8.1 As recommended in annex *XX*, a number of steps need to be taken to improve the quality of disclosure by corporations. Improvements in this area will in turn help to improve compliance with market integrity rules, as well as the effectiveness of market surveillance programs, as noted in part 4 of our findings above.

Annex 7: Enforcement and Investigations at the Exchanges

I. Background and Discussion

Both the NSE and BSE have investigations and enforcement functions –for the purposes of this report the structure of these functions, it has not been possible to review the functions in detail.

At the BSE investigations are not centralized in a particular department. Each department, including listings, surveillance and inspections, can initiate an investigation. Once an investigation is completed, a group of senior managers considers staff's recommendation to either pass the investigation to SEBI (if it involves third parties, for example, and is outside of the exchange's jurisdiction), assess a penalty directly or pass the investigation to the disciplinary committee for hearing. Minor matters are dealt with by management and more complex or serious issues by the disciplinary committee –the restrictions and limitations are clearly set out in the Inspections Manual. A broker has the right to request the matter be heard by the disciplinary committee. Management can issue a warning letter or a small fine. The disciplinary committee can issue a warning letter, levy a larger fine or suspend a member from trading.

Prior to the dismissal of brokers from the Board, the disciplinary committee was composed of 40% members and 60% non members drawn from the Board?. A show cause notice is served on the member prior to the disciplinary committee proceedings and the member has the ability to respond in writing and to appear before the committee. Show cause notices are not normally published although the exchange may do so at its discretion. Final decisions of the disciplinary committee are announced through a press release but the decision itself is not public.

At the NSE all investigations beyond the initial investigations stage are handled by the same department. There is no management decision route for disciplinary actions. All files are vetted by the head of the department before becoming full investigations and again before proceeding to disciplinary committee. The disciplinary committee consists of the managing director and five board members (none of whom are brokers). The disciplinary committee can issue a warning letter, levy a fine or suspend a member from trading.

A huge volume of complaints are handled by the exchanges –the majority of these complaints are with respect to listed companies (non payment of dividends and failure to transfer shares being the most common of these). Complaints against brokers –by other brokers as well as clients –are initially handled by the complaints department. Both exchanges resolve some complaints in the complaints department itself. In the case of a complaint against a broker, the complaint is not resolved it may be passed on to arbitration panel or on to another exchange department for further investigation. Those that go on to further investigation may result in disciplinary proceedings.

Arbitrations on the BSE are conducted by a board consisting of a combination of member and non-member representatives (with all non-members being SEBI approved). Arbitrations on both exchanges often deal with the fall-out from member defaults (for example, the client pursuing the broker for delivery or the broker pursuing the client for payment).

Both exchanges send monthly reports of status of investigation and enforcement activities to SEBI.

II. Findings

The enforcement and investigation process is not transparent: Both exchanges have an aversion to publishing disciplinary proceedings, at any stage. There is no information available to the public regarding a broker's disciplinary history and there is no body of precedent transparent to the brokerage or legal community.

Investigation and enforcement functions are decentralized: The exchanges have not created enforcement departments separate from other functions –instead investigations are carried out by more than one department and enforcement actions are brought by staff from these departments or the legal department.

III. Recommendations

Transparency in disciplinary process: The exchanges should have transparent policies and procedures for investigations and for enforcement hearings. These procedures should be published on the exchange's website and must be approved by SEBI prior to their introduction. All final decisions of the exchange must be public and must be published on the exchange. The exchange should be required to report regularly to SEBI on status of enforcement proceedings –there should be monthly status reports made in writing and there should be an additional obligation to report significant issues as they arise.

Investigations and enforcement should be further centralized at the exchanges: The exchanges should have separate enforcement departments to handle prosecution of cases before the disciplinary committees and to formulate policies and procedures for enforcement proceedings. The BSE might also consider further centralizing its investigations functions since these are spread throughout a number of departments.

Annex 8: Risk Management Capital and Brokerage Industry Consolidation

Annex 9: Proposals For The SRO Structure In The Indian Capital Markets

I. Background

The mission has identified several issues and needs relating to the Indian stock exchanges' role as self-regulatory organizations (SROs). In order to improve regulation of the markets, the SROs' regulatory activities must be expanded and their resources increased. In addition, their activities must be far more coordinated, so that each SRO is looking at all relevant market activity, not just its own exchange, when addressing an issue. At the same time, the imminent demutualization of the Indian exchanges raises questions about the most effective way to deliver SRO functions. The primary question is: should the Exchanges continue to carry out SRO functions separately, or should some or all of these functions be centralized in a new self-regulatory organization?

A. Current Structure

The primary features of the current structure for SROs in India are:

- The stock exchanges are the only SROs;
- The system is very fragmented due to the large number of exchanges, resulting in overlap, duplication, differing practices and procedures and variable commitment to and resourcing of regulatory functions;
- There is a lack of consolidating mechanisms to address the problems created by fragmentation in the system; even basic information-sharing among the exchanges has not been developed;
- The exchanges have not clearly separated their regulatory and business functions in their organizational structures; there is no clear delineation of self-regulatory functions.

The current SRO functions of the Exchanges are quite basic, since their regulatory functions are tied directly to their functions as exchanges. The basic functions are limited to Market Surveillance (including related investigations), which was only introduced several years ago, and the risk management or margining functions related to clearing house risk. In addition, their Listings functions are regulatory in nature, and involve monitoring compliance with the Listings Agreement. But Listings is not, strictly speaking, a self-regulatory function akin to the brokers regulating themselves through SRO membership.

Therefore, the current regulatory activities of the Exchanges are directly tied to their basic function of trading securities and ensuring trades settle. As such, it was not considered necessary to insist on strict separation of business and regulatory activities. Traditionally, the conflicts of interest inherent in any self-regulatory system were managed through SEBI oversight and the governance systems of the Exchanges. As we have seen, problems exist in both areas.

The exchanges have never, in their capacity as SROs, been required to take on regulatory functions of a quasi-public nature that are not tied to their exchange operations, such as member regulation or broker supervision functions. These include elements such as monitoring financial stability and compliance with capital requirements, reviewing compliance systems and procedures, supervising brokers' handling of clients and client accounts, and so on.

II. International Comparisons

The Indian exchanges' approach to self-regulatory functions is consistent with the organization of many exchanges outside of the U.S. in the past. (The U.S. model has always featured greater separation of business and regulatory functions, although to a lesser degree at the small regional exchanges.) With the demutualization and commercialization of exchanges, the approach to the organization and delivery of SRO functions is in a state of flux. Governments and securities commissions, as well as exchanges themselves, are reassessing whether it is appropriate for demutualized exchanges to continue to act as SROs and, if they continue to perform regulatory functions, what the organizational structure should be to ensure conflicts of interest are managed appropriately.

With demutualization of exchanges, new conflicts of interest have emerged: the conflict between profit maximization and the considerable costs of investment in and operation of regulatory functions; and the conflict inherent in a commercial entity regulating firms it is competing with (eg. ATSs that are members, listed companies the exchange is competing or partnering with, etc.). Regulators and exchanges around the world are currently grappling with these changes, and no definitive model, or consensus on best practice, has emerged to date.

In summary form, some of the approaches in other jurisdictions are:

- In the U.S., the NASD has established NASD Regulation as an independent SRO focussed solely on regulatory activities. It remains owned by its member broker-dealers. The Nasdaq Stock Market is being sold to various investors, and is planning a public listing this year.
- Also in the U.S., the NYSE and other stock exchanges are debating demutualization and how to handle their SRO functions. One of the main reasons the NYSE had delayed demutualization is reportedly the SEC's insistence that NYSE separate its regulatory functions. The NYSE views its services as an integrated package which would be compromised if it is forced to unbundled them.
- In the UK, the LSE relinquished member regulation functions almost 15 years ago. The FSA recently assumed the regulatory functions associated with listing and listed companies. The LSE's remaining SRO function is market supervision

of its members. This function is seen as quality control of its market and is not clearly separated from business operations.
- In Canada, the demutualized Toronto Stock Exchange is spinning off its market regulation functions into an affiliated company that it will own 60% of. The company is being established as a central SRO to regulate all markets, including exchanges and ATSs. The TSE relinquished member regulation functions to a separate member-owned SRO in 1997.
- In Australia, the demutualized ASX has established a separate company to oversee the delivery of its regulatory and listing functions, but will continue to actually carry out regulatory operations within ASX. In Australia, much attention has been focussed on the conflict between regulating listed companies and the ASX operating as a commercial entity.
- In Europe, the concept of self-regulation has always been different and more limited, with government supervisory authorities being directly responsible for more regulatory functions, especially broker-dealer supervision and regulation. As a result, conflicts arising from demutualization of exchanges are more limited. Demutualized exchanges such as Euronext continue to operate regulatory functions such as listing and market surveillance as departments. In Germany, all exchanges including Deutsche Borse have long been required to support independent market surveillance units that report to government authorities in carrying out their market regulation activities.

To summarize, a self-regulatory system must manage 3 kinds of conflict of interest today:

- Conflict inherent in a profession regulating itself;
- Conflict arising with a for-profit entity acting as a SRO;
- Conflict arising with a for-profit entity regulating competitors.

A. Business Interest of Exchanges

The above looks at the issue from a regulatory perspective. One must also consider the issue from the standpoint of operating a demutualized exchange as a business. There are basically two points of view on this today.

The first, epitomized by NYSE, views regulatory functions as part and parcel of the business, and sees unbundling of functions as a threat to the quality, reputation or "brand" of the exchange.

The second, best illustrated by Nasdaq, sees the conflicts of operating a competitive business and an SRO simultaneously as impossible to manage – either or both functions will be compromised by the twin mandate. If the business is also operating as a SRO, the exchange must serve two mandates from a governance point of view: 1) profit maximization; 2) regulating in the public interest. This twin mandate is difficult to reconcile at both a governance (Board of Directors) and management level. A commercial company is expected to maximize shareholder value, and the directors' duty is to act in the best interests of the shareholders. The mandate of an SRO is to act in the public interest, or the best interests of investors and the capital markets, and the directors' duty is to ensure effective self-regulation. In the latter role, the company must be supervised by and responsive to the government regulator.

B. Proposed Regulatory Changes for Indian Markets

We envision both a rearrangement and an expansion of securities regulation activity in India in order to improve compliance and market integrity. In terms of functions, the highlights of this package will likely be:

- Introduction of a complete member regulation program, encompassing compliance and investor protection, as well as financial risk management;
- Expansion and coordination of the market surveillance and investigation functions of the exchanges;
- Expansion of the SRO enforcement functions;
- Relocation of settlement risk management to the clearing houses;
- Overhaul of SEBI's structure, and expansion of all of its regulatory activities;
- Transfer of primary responsibility for regulation of public companies securities market activities to SEBI from the exchanges.

At the same time, other regulatory and market structure changes are sweeping the Indian markets, including:

- demutualization of most exchanges, particularly BSE;
- potential public listing of demutualized exchanges;
- consolidation of exchanges, with many exchanges acting as SROs likely merging or going out of business;
- consolidation of brokerages;
- expansion of foreign investment in the market;
- the market reforms being introduced in July, including rolling settlement.

The broad scope of all of this change in a short period of time poses many challenges for market participants and the regulatory system. One of the main challenges is to determine how SRO functions should best be delivered in an environment where these functions must be expanded and professionalized, will consume much greater resources, and the organization and objectives of the exchanges are changing fundamentally.

III. Demutualization of Exchanges

On March 13, 2001 the Finance Minister announced in Parliament that all of the stock exchanges would be demutualized in the aftermath of the "market scam" and related issues that became the subject of political scrutiny. In this context, demutualization is seen mainly as a public policy initiative being taken to address regulatory issues in general, and the conflict of interest arising in exchanges owned and, to a significant degree, run by brokers. In other words, the other exchanges will be required to move in the same direction as the National Stock Exchange, and separate ownership from trading rights.

It is important to recognize the difference between this view of demutualization and the international view. In India, demutualization refers primarily to the separation of ownership (and control) from trading rights. The primary purpose is to address the conflict of interest which has always been present in self-regulatory organizations. In the rest of the world, demutualization is a business strategy being pursued by exchanges themselves in response to a much more competitive environment for exchange services. They are converting from cooperatives owned by their members, to corporations run on a commercial, for-profit basis. Many exchanges are becoming public companies listed on their own markets, with a broad base of shareholders or owners. In these cases, the board of directors is usually elected by shareholders.

Others have not taken this step, and remain owned in whole or in part by their former member brokerage firms, although ownership has been separated from the right to trade. In these cases, the brokerage firms as shareholders continue to take an active role in the governance of the exchanges, by electing directors to sit on the board. The number of directors elected by the brokerage firms varies around the world, but even prior to demutualization, exchanges generally had a number of independent or "public" directors not associated with brokerage firms. In many jurisdictions, the best practice was viewed as requiring at least 50% of the directors of an exchange or SRO to be independent.

Demutualization of exchanges carrying out SRO functions also requires the concept of self-regulation to be re-examined. An exchange owned and, in varying degrees, governed by its members is self-regulatory to the extent of member involvement in developing the rules and policies of the exchange. An exchange that is not member-owned cannot, strictly speaking, be self-regulatory, because the regulated entities, the brokerage firms, are no longer central to the governance and operation of the exchange. In this case, an exchange that continues to carry out regulatory functions is in fact operating as a private regulator by authorization of the governmental authority.

In contrast, a SRO that is not an exchange and that continues to be owned by its member firms, remains self-regulatory in nature. NASD Regulation Inc. is the foremost example of this model. It is strictly a SRO; unlike an exchange it does not operate a market or any commercial business.

[insert examples of demutualized exchanges' governance from other jurisdictions]

IV. Implementing Demutualization in India

In summary, in implementing demutualization of exchanges, the authorities need to balance several policy objectives:

- the decision to separate ownership and trading rights, in order to address conflict of interest issues;
- the exchanges' need to focus on developing a competitive business;

- implementation of an effective SRO structure.

Given the varying sizes, nature and commercial viability of the exchanges, mandating a single approach to demutualization is not recommended. For example, NSE has long been demutualized in terms of separation of ownership from trading rights, but it is not strictly-speaking operated as a for-profit commercial company. It is owned by institutional investors. The BSE, on the other hand, appears to be aiming to become a commercial company listed on its own market, with public shareholders. In the interim, until that step is achievable, it may continue to be owned by its former member brokers, utilizing a new governance structure, and separating its regulatory functions into an independent affiliate. This is consistent with the approach that a number of other exchanges have taken around the world. The demutualization process should accommodate both of these approaches, and other variants, provided that the fundamental public policy objectives noted above are achieved.

The primary danger in mandating a single approach to demutualization is that, rather than a competitive and innovative securities market developing based on c competition among the business strategies of each exchange, a uniform government-mandated model for the organization of exchanges will emerge. Such an approach ignores the commercial imperatives of the demutualization process, and the need for the Indian securities market to develop markets which are internationally competitive.

[Analyze requirements to meet these objectives in terms of ownership, mandate, Board structure, management, organizational structure etc. Discuss market structure implications.]

A. Potential Regulatory Structures

Before addressing the alternatives, it is first necessary to define all of the regulatory activities that the SRO system will be expected to deliver. We foresee the following activities being carried out, in whole or in part, at the SRO level:

1. Market surveillance of equity, debt and derivatives markets
2. Investigation and enforcement of market and trading rules for brokers
3. Standards of conduct, general compliance and client relationship rules for brokers
4. Capital and financial adequacy standards for brokers
5. Broker inspections relating to 3 and 4
6. Investigation and enforcement of member regulation rules for brokers
7. Risk management rules and systems of clearing houses, for cash and derivative markets
8. Listing of securities and compliance with exchanges' listing agreements

(Note: we recommend most regulation of corporates be transferred to SEBI.)

If this approach is pursued, it is clear that the SRO functions will require a much greater investment of resources than they do today. SEBI will also have to develop the ability to effectively oversee the satisfactory delivery of SRO functions.

B. Delivery of SRO functions in the Indian context

We see 2 generic alternatives for the delivery of SRO functions in India:

Create a new central SRO

Pros

- Minimizes conflicts of interest
- Mandate focussed on effective regulation
- Eliminates fragmentation in delivery of SRO functions
- Ensures consistent, uniform policies and procedures
- Eliminates costs of overlap and duplication

Cons

- Forces exchanges to unbundle services they may view as central to their services and market quality or "brand"
- Separates regulatory staff from the market
- Could become an arm of SEBI instead of a self-regulator
- Must resolve significant questions of principle:
  - ➢ Which SRO functions will be moved to the new SRO – all or just some, with some functions (eg. Listing) left at exchanges?
  - ➢ Who will own the SRO?
  - ➢ What will the composition of the Board be?
  - ➢ How will the SRO be funded?

Reorganize the exchanges' SRO operations

This alternative raises fewer questions, but a basic question is whether the exchanges, especially BSE and NSE, are prepared to assume all of these regulatory functions and the associated costs. It must also be decided what organizational structure will be implemented to address conflicts of interest. Finally, this approach places heavy reliance on cooperation and information-sharing among the exchanges. SEBI would need to take an active role in ensuring that effective cooperation occurs among the exchanges to ensure consistent and sufficiently coordinated regulatory functions are carried out.

Pros

- Minimizes scope of institutional change by utilizing existing SROs
- Regulatory staff remain close to the market
- Exchanges not required to unbundle services at this time

Cons

- Demutualized exchanges may not be committed to expanded regulatory functions; may divert focus from building competitive markets

- Fragmentation of SRO functions remains; relies on cooperation and SEBI oversight to overcome the problems this creates
- Some overlap and duplication, and inconsistency in policy and procedures, **is inevitable**

Other Considerations

Given the forces at play in the Indian markets, the rapid pace of change and the current state of development of competition within the markets, it is very difficult to determine if it is appropriate to launch a new SRO at this time. Is the market is ready to accommodate a new and independent SRO? Some of the factors to be taken into account are:

- SEBI is likely to be substantially overhauled, which should be the main priority. It is difficult to overhaul the SRO structure simultaneously, especially given that SEBI has a significant role to play in the organization and launch of such an SRO. SEBI is currently not ready to play this role, and will not be until its own restructuring is completed.
- Can SEBI be successfully restructured and sufficiently resourced to carry out a great deal of the new and expanded regulatory functions directly? If not, a new central SRO which exercises expanded powers and functions that would otherwise lie with SEBI would be a means of delivering an expanded level of regulatory services.
- The timetable for demutualization of exchanges is accelerated based on the government's policy decision in this area. Substantial changes to the SRO structure will delay this timetable if the two issues (effecting demutualization and resolving the SRO structure) are not separated in the short term;
- Except for NSE, the exchanges have just started the demutualization process. It is not clear, for example, what form BSE's demutualization will take. The BSE itself has not decided what course it wants to pursue, and BSE's objectives should be taken into account.
- NSE continues to view its services as an integrated package, similar to the NYSE view. Even NSE has yet to develop into a fully commercial venture operating in a competitive environment characteristic of developed markets (where, for example, ATSs and foreign competition are major forces). NSE's future business objectives should be taken into account.
- It is not clear how much consolidation will occur among exchanges. If some regional exchanges continue, the system must ensure their SRO functions are being delivered effectively.
- The concept a broker-run SRO akin to NASDR is difficult to envision in an environment where the brokerage industry lacks credibility and integrity, and is in an immature state of development from a compliance perspective. If the SRO is not owned at least in part by brokers, it is not really self-regulatory in nature, which begs the question of how to structure ownership, governance and funding in a manner which differentiates the entity from the government regulator, SEBI.
- Grafting a foreign model for delivery of SRO functions onto the Indian market at this stage in the development of demutualized exchanges globally could be a

mistake, because as noted above it is not clear what the preferred international model will be for demutualized exchanges' handling of their SRO functions. Current approaches vary widely, and the models will likely evolve significantly in the coming years.

It is possible that if the Indian exchanges consolidate to 2 or 3 markets and become fully commercial, shareholder-owned ventures, they will either choose to, or be required to, reorganize or spin off all or part of their SRO functions in future, when the conflicts are magnified and sharper. Even if this occurs in future, when and exactly how it occurs will depend on how the Indian market develops, including factors such as:

- The degree of consolidation of exchanges;
- Intensity of competition for liquidity, and whether one exchange comes to dominate or not;
- Whether and when the exchanges choose to become fully commercial;
- Degree of openness to foreign investment and competition from foreign stock markets;
- Future regulatory and compliance developments (ie. If further problems occur, this will clearly influence institutional developments).

V. Recommendations

- Establish a process for the key stakeholders in the securities markets to discuss the process of demutualization, and how best to achieve the major policy objectives of the new regime.
- Locate new SRO functions at the exchanges during the current demutualization process, and consider creating a new central SRO in future as the market system matures.
- Empower SEBI to set the primary regulations relating to capital requirements, brokers' operations and issuers, while delegating administration of many member regulation functions to the exchanges.
- Rather than mandating one model for demtualization, permit exchanges to determine an approach to demutualization that meets their business objectives in a competitive market, subject to SEBI oversight to ensure effective delivery of SRO functions.
- Permit each exchange to choose its own structure for SRO functions, subject to SEBI oversight, and a minimum standard of creating a separate department for all regulatory functions, with appropriate firewalls to ensure segregation of regulatory and business information and activities.
- Require the exchanges to cooperate in all regulatory functions, with the objective of increasing regulatory effectiveness and compliance, encouragement of best practices, and minimization of duplication and cost.
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    a. coordinate market surveillance monitoring and investigation on an ongoing basis as suggested in Surveillance note,

b. coordinate member regulation / broker oversight by establishing minimum standards at SEBI level, assigning each broker to one exchange for supervision purposes, and requiring exchanges to cooperate in the development of compliance programs,
c. coordinate continued listings monitoring by assigning each company that is listed on more than one exchange to a "primary exchange" for monitoring purposes (which would normally be the exchange with the highest market share in the stock)
d. coordinate risk management at their clearing houses by sharing information, policies and practices.

- Make SEBI clearly responsible, through its oversight program, for ensuring that conflicts of interest are managed and regulatory programs of the exchanges coordinated (including direct involvement of SEBI where appropriate) in an effective and professional way, while also clarifying that SEBI should encourage competition on the business side of the markets and not make regulatory interventions that would impede competition or business development. In order to encourage these results, maximum transparency should apply to oversight activities.

Note: The paper could go on to recommend steps for implementation of the alternative SRO structures, as another stage of the process.